CLERK'S COPY.

CERTIFICATE

Supreme Court of the United States

OCTOBER TERM, 1935

No. 743

FRANK O. LOWDEN, JAMES E. GORMAN AND JOSEPH B. FLEMING, AS TRUSTEES OF THE ESTATE OF THE CHICAGO, ROCK ISLAND AND PACIFIC RAILWAY COMPANY,

vs.

NORTHWESTERN NATIONAL BANK AND TRUST COMPANY OF MINNEAPOLIS, MINNESOTA, FORMERLY THE NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS, MINNESOTA

ON CERTIFICATE FROM THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

FILED FEBRUARY 5, 1936.

SUPREME COURT OF THE UNITED STATES

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[fol. 1]

IN UNITED STATES CIRCUIT COURT OF APPEALS, EIGHTH CIRCUIT

NOVEMBER TERM, A. D. 1935

No. 10,390

FRANK O. LOWDEN, JAMES E. GORMAN and JOSEPH B. FLEMING, as Trustees of the Estate of the Chicago, Rock Island and Pacific Railway Company, Appellants,

vs.

NORTHWESTERN NATIONAL BANK AND TRUST COMPANY OF MINNEAPOLIS, MINNESOTA, Formerly the Northwestern National Bank of Minneapolis, Minnesota, Appellee

Appeal from the District Court of the United States for the District of Minnesota

Certificate of Questions– Filed Jan. 24, 1936

STATEMENT OF CASE

The United States Circuit Court of Appeals for the Eighth Circuit certifies that the record on an appeal in the above case now pending discloses the following:

The Chicago, Rock Island and Pacific Railway Company is a railroad corporation organized under the laws of Illinois and Iowa, with its principal place of business in Chicago. On June 7, 1933, at 9:55 o'clock A. M., the railroad, desiring to effect a plan of reorganization pursuant to section 77 of the Bankruptcy Act as amended (11 U. S. C. § 205), filed with the United States District Court for the Northern District of Illinois, Eastern Division, its petition for reorganization under that section. The petition alleged that the railroad was unable to meet its debts as they matured. Upon the filing of the petition, a judge of the court wherein it was filed approved it as being properly filed under said section 77.

[fol. 2] At the time of the filing of the petition (9:55 A. M., June 7, 1933), the railroad had to its credit in a

checking account with the Northwestern National Bank and Trust Company of Minneapolis, a national bank, the sum of $36,908.72. At the close of business on that day, the amount to the credit of the railroad in said account was $45,362.94. The bank on June 7, 1933, owned $100,000.00 par value of First and Refunding Gold Bonds of the railroad. These bonds were not then due and would not by their terms become due until April 1, 1934, and there had been no default upon the bonds in the payment of either principal or interest.

On June 19, 1933, seven days after it received a copy of the order of the United States District Court for the District of Illinois approving the petition for reorganization filed by the railroad, the bank set off the $45,362.94 which was to the railroad's credit with it at the close of banking hours on the day the petition was filed, against the $100,000.00 of bonds of the railroad owned by the bank by charging the railroad's account with that amount and crediting the same upon the bonds.

In so doing, the bank relied upon section 68(a) of the Bankruptcy Act (11 U. S. C. § 108) which provides:

"In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid";

and upon paragraph (n) of section 77 which provides:

"In proceedings under this section and consistent with the provisions thereof, the jurisdiction and powers of the court, the duties of the debtor and the rights and liabilities of creditors, and of all persons with respect to the debtor and his property, shall be the same as if a voluntary petition for adjudication had been filed and a decree of adjudication had been entered on the day when the debtor's petition was filed."

[fol. 3] The railroad protested the set-off and denied the right of the bank to make it. On June 23, 1933, the bank restored to the account of the railroad the sum of $5,611.32, making the net sum deducted from the account for the purposes of set-off $39,751.62. This restoration was made by the bank because on June 10, 1933, three days after the

filing of the petition for reorganization, the balance in the account of the railroad with the bank had been drawn down to $39,751.62 which was the lowest amount standing to the credit of the railroad on the books of the bank between the time of the filing of the petition for reorganization and the time the bank made the set-off. The set-off was made voluntarily by the bank and was not ordered, authorized, approved, or consented to by the court in which the petition for reorganization was filed.

After trustees were appointed for the railroad pursuant to section 77, they brought suit in the United States District Court for the District of Minnesota to recover the amount of the set-off. That court held that section 68(a), supra, was applicable to proceedings under section 77, and that the bank was therefore entitled to the set-off; but fixed the amount which the bank was entitled to set off at $36,908.72, being the amount on deposit at 9:55 A. M. June 7, 1933, when the petition for reorganization was filed.

It is further certified that the following questions of law arise from this record, are presented and are undetermined, and decision thereof is indispensable to a determination of the case. To the end that this court may properly discharge its duty, it desires the instruction of the Supreme Court thereon:

Questions Certified

Question 1. Does the right of set-off recognized by section 68(a) of the Bankruptcy Act apply to reorganization [fol. 4] proceedings under section 77 of that act?

Question 2. If the first question be answered in the affirmative, can a bank which owns the unmatured bonds of a railroad corporation set off a deposit account of the railroad with the bank against the bonds, upon the filing by the railroad of a petition for reorganization under section 77 of the Bankruptcy Act, alleging that the railroad is unable to meet its debts as they mature?

Question 3. If the first and second questions be answered in the affirmative, may the United States District Court, for the District of Minnesota, in the suit by the trustees of the railroad's estate to recover the amount deducted from the account of the railroad by the bank under the claimed right of set-off, recognize and establish as a proper set-off

by the bank one which was not made until after the filing of the petition for reorganization and which has never been ordered, authorized, approved, or consented to by the court in which that petition was filed and approved?

Archibald K. Gardner, United States Circuit Judge.
John B. Sanborn, United States Circuit Judge.
J. W. Woodrough, United States Circuit Judge.

[File endorsement omitted.]

[fol. 5] In United States Circuit Court of Appeals, Eighth Circuit

[Title omitted]

Order of Transmittal

Certain questions having arisen on the record in this cause, upon which this Court desires the instructions of the Supreme Court of the United States as provided by law, and a certificate of such questions having been prepared and duly signed. It is now here ordered by this Court that such certificate be filed and entered of record in this Court and that the original thereof be duly certified by the Clerk of this Court and that it be by him duly transmitted to the Supreme Court of the United States for its action thereon.

January 24, 1936.

[fol. 6] In United States Circuit Court of Appeals, Eighth Circuit

Clerk's Certificate

I, E. E. Koch, Clerk of the United States Circuit Court of Appeals for the Eighth Circuit, do hereby certify that the foregoing certificate in the case of Frank O. Lowden, et al., Appellants, vs. Northwestern National Bank and Trust Company of Minneapolis, Minnesota, etc., No. 10390, was duly filed and entered of record in my office by order of said Court, and as directed by said Court, the said certificate is by me transmitted to the Supreme Court of the United States for its action thereon.

In Testimony Whereof, I hereunto subscribe my name and affix the seal of the United States Circuit Court of Appeals for the Eighth Circuit, at office in the City of St. Louis, Missouri, this 30th day of January, A. D. 1936.

E. E. Koch, Clerk of the United States Circuit Court of Appeals for the Eighth Circuit. (Seal United States Circuit Court of Appeals, Eighth Circuit.)

Endorsed on cover: File No. 40,297. U. S. Circuit Court of Appeals, Eighth Circuit. Term No. 743. Frank O. Lowden, James E. Gorman and Joseph B. Fleming, as Trustees of the Estate of the Chicago, Rock Island and Pacific Railway Company, vs. Northwestern National Bank and Trust Company of Minneapolis, Minnesota, Formerly the Northwestern National Bank of Minneapolis, Minnesota. Certificate. Filed February 5, 1936. Term No. 743, O. T., 1935.

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Supreme Court of the United States

OCTOBER TERM, 1935.

No. 743.

FRANK O. LOWDEN, JAMES E. GORMAN, and JOSEPH B. FLEMING, as Trustees of the Estate of THE CHICAGO, ROCK ISLAND AND PACIFIC RAILWAY COMPANY,

Appellants Below,

vs.

NORTHWESTERN NATIONAL BANK AND TRUST COMPANY OF MINNEAPOLIS, MINNESOTA, formerly THE NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS, MINNESOTA,

Appellee Below.

NOTICE OF MOTION
AND
MOTION TO BRING UP ENTIRE RECORD AND CAUSE.

M. L. BELL,
DANIEL TAYLOR,
ALEXANDER E. HORN,
EDWARD S. STRINGER,
Counsel for Appellants Below.

Review Publishing Co., 141 E. Fifth St., St. Paul, Minn.

Supreme Court of the United States

OCTOBER TERM, 1935.

No. 743.

FRANK O. LOWDEN, JAMES E. GORMAN, and JOSEPH B. FLEMING, as Trustees of the Estate of THE CHICAGO, ROCK ISLAND AND PACIFIC RAILWAY COMPANY,

Appellants Below,

vs.

NORTHWESTERN NATIONAL BANK AND TRUST COMPANY OF MINNEAPOLIS, MINNESOTA, formerly THE NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS, MINNESOTA,

Appellee Below.

NOTICE OF MOTION.

TO MESSRS. CLAUDE G. KRAUSE AND GLENN S. STILES, COUNSEL FOR APPELLEE BELOW:

PLEASE TAKE NOTICE, That on the 17th day of February, 1936, or as soon thereafter as counsel can be heard, the within motion to bring up the entire record and cause will be submitted to the Supreme Court of the United States

in Washington, D. C. A copy of the motion to bring up the entire record and cause is served upon you herewith.

Respectfully,

M. L. BELL,
DANIEL TAYLOR,
ALEXANDER E. HORN,
EDWARD S. STRINGER,
Counsel for Appellants Below.

Due service of the within motion to bring up the entire record and cause, and notice thereof, is hereby admitted this ..... day of February, 1936, and consent is hereby given that said motion be submitted to the Supreme Court of the United States at said time.

.....

.....

Counsel for Appellee Below.

Supreme Court of the United States

OCTOBER TERM, 1935.

No. 743.

FRANK O. LOWDEN, JAMES E. GORMAN, and JOSEPH B. FLEMING, as Trustees of the Estate of THE CHICAGO, ROCK ISLAND AND PACIFIC RAILWAY COMPANY,

Appellants Below,

vs.

NORTHWESTERN NATIONAL BANK AND TRUST COMPANY OF MINNEAPOLIS, MINNESOTA, formerly THE NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS, MINNESOTA,

Appellee Below.

MOTION TO BRING UP ENTIRE RECORD AND CAUSE.

Now come Frank O. Lowden, James E. Gorman, and Joseph B. Fleming, as Trustees of the Estate of The Chicago, Rock Island and Pacific Railway Company, appellants in this cause in the United States Circuit Court of Appeals for the Eighth Circuit, which is now pending in this Court on questions certified by said Circuit Court of Appeals, and move that this Court order that the entire record and cause be brought up and that it issue its writ of certiorari commanding the said Circuit Court of Appeals for the Eighth Circuit to certify and send to this Court a true and complete transcript of the record in this cause.

A certified transcript of this record, together with nine printed copies, has been lodged with the Clerk of this Court as an exhibit to this motion. An inspection thereof will show that this motion should be granted for the following reasons:

(1) A summary of the facts and the questions contained in the certificate on file is as follows:

The Chicago, Rock Island and Pacific Railway Company, a railroad corporation organized under the laws of Illinois and Iowa, desiring to effect a plan of reorganization pursuant to Section 77 of the Bankruptcy Act as amended (11 U. S. C. Section 205), on June 7, 1933, filed with the United States District Court for the Northern District of Illinois, Eastern Division, its petition for reorganization under that section. The petition alleged that the railroad was unable to meet its debts as they matured. Upon the filing of the petition, it was approved as properly filed under Section 77.

At the time of the filing of the petition, the railroad had to its credit in a checking account with the Northwestern National Bank and Trust Company of Minneapolis, a national bank, the sum of $36,908.72. Later deposits made the same day brought the amount up to $45,362.94 at the close of business. The bank on that day owned $100,000 par value of First and Refunding Gold Bonds of the railroad. These bonds were not then due and would not by their terms become due until April 1, 1934, and there had been no default upon the bonds in the payment of either principal or interest. On June 19, 1933, the bank set off $45,362.94 (the amount to the railroad's credit at the close of business on June 7, 1933,) against $100,000 of the bonds of the railroad owned by

the bank by charging the railroad's account with that amount and crediting the same upon the bonds. The railroad protested the set-off and denied the right of the bank to make it. Later, the bank restored to said account a portion of the amount deducted. The set-off was made voluntarily by the bank and was not ordered, authorized, approved, or consented to by the Court in which the petition for reorganization was filed. After trustees were appointed for the railroad pursuant to Section 77, they brought suit in the United States District Court for the District of Minnesota to recover the amount of the set-off.

The United States Circuit Court of Appeals certified to this Court the following questions:

> "Question 1. Does the right of set-off recognized by section 68 (a) of the Bankruptcy Act apply to reorganization proceedings under section 77 of that act?
>
> "Question 2. If the first question be answered in the affirmative, can a bank which owns the unmatured bonds of a railroad corporation set off a deposit account of the railroad with the bank against the bonds, upon the filing by the railroad of a petition for reorganization under section 77 of the Bankruptcy Act, alleging that the railroad is unable to meet its debts as they mature?
>
> "Question 3. If the first and second questions be answered in the affirmative, may the United States District Court, for the District of Minnesota, in the suit by the trustees of the railroad's estate to recover the amount deducted from the account of the railroad by the bank under the claimed right of set-off, recognize and establish as a proper set-off by the bank one which was not made until after the filing of the petition for reorganization and which has never been ordered, authorized, approved, or consented to by the court in which that petition was filed and approved."

(2) The statement of the case contained in said certificate is not sufficiently complete to enable this Court to answer the second question as applied to this case. The answer to such question of necessity involves a determination of whether the railroad bank account and the First and Refunding Bonds held by the bank were "mutual debts or mutual credits" within the meaning of Section 68 of the Bankruptcy Act. Such question cannot be determined upon the mere statement that the bank owed the railway upon a deposit account and the bank held First and Refunding Bonds of the railway which were not yet due. The record, which is filed as an exhibit hereto, shows the following facts which do not appear from the statement of the case contained in the certificate of the Court below, to-wit:

(a) The First and Refunding Bonds held by the bank were issued April 1, 1904, and were due April 1, 1934. They were payable in New York City, both as to principal and interest, and were secured by trust deed upon the properties of the railway. Interest was evidenced by coupons attached to the original bonds, payable April 1, and October 1 of each year. All bonds held by the bank were payable to bearer. The total authorized issue of such First and Refunding Bonds was $163,000,000, of which more than $104,000,000 was issued and in the hands of the public. These bonds were and are quoted on the New York Stock Exchange and other stock exchanges, and were dealt in by security holders in all parts of the world.

(b) The bonds held by the bank, and which it attempted to use as a set-off, were not purchased by it from the railway, but were purchased in New York City on the open market, some from the Guaranty Trust Company and some from the National City Company. They were acquired by the bank between November, 1927, and October, 1930, at prices ranging from 94¾ to

99⅜. There were no direct dealings with respect to said bonds between the bank and the railway.

(c) The railway did not keep any record of the holders of its outstanding bonds which were payable to bearer, and did not know that the bank owned these particular bonds.

These facts are essential to a determination of the second question certified.

Scott vs. Armstrong, 146 U. S. 499.

Hanover National Bank vs. Suddath, 215 U. S. 122.

United States Fidelity Company vs. Woolridge, 268 U. S. 234.

Carr vs. Hamilton, 129 U. S. 252.

New York County National Bank vs. Massey, 192 U. S. 138.

This Court should have the entire record before it in order to show such facts.

Respectfully submitted,

M. L. BELL,
DANIEL TAYLOR,
ALEXANDER E. HORN,
EDWARD S. STRINGER,
Counsel for Appellants Below.

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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1935

No. 743

FRANK O. LOWDEN, JAMES E. GORMAN and JOSEPH B. FLEMING, as Trustees of the Estate of THE CHICAGO, ROCK ISLAND AND PACIFIC RAILWAY COMPANY,

Appellants Below,

vs.

NORTHWESTERN NATIONAL BANK AND TRUST COMPANY OF MINNEAPOLIS, MINNESOTA, formerly THE NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS, MINNESOTA,

Appellee Below.

ON CERTIFICATE FROM THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

BRIEF AND ARGUMENT FOR APPELLANTS BELOW.

ALEXANDER E. HORN,
EDWARD S. STRINGER,
DANIEL TAYLOR,
MARCUS L. BELL,
Counsel for Appellants Below.

OTIS F. GLENN,
Of Counsel.

State Law Printing Company, 173 W. Madison St., Chicago--FRAnklin 5501

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IN THE

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OCTOBER TERM, A. D. 1935

No. 743

FRANK O. LOWDEN, JAMES E. GORMAN and JOSEPH B. FLEMING, as Trustees of the Estate of THE CHICAGO, ROCK ISLAND AND PACIFIC RAILWAY COMPANY,

Appellants Below,

VS.

NORTHWESTERN NATIONAL BANK AND TRUST COMPANY OF MINNEAPOLIS, MINNESOTA, formerly THE NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS, MINNESOTA,

Appellee Below.

ON CERTIFICATE FROM THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

BRIEF AND ARGUMENT FOR APPELLANTS BELOW.

I.

Reference to Opinion Below.

Lowden v. Northwestern National Bank and Trust Company of Minneapolis (U. S. D. C. Minnesota), 11 Fed. Supp. 929, filed June 17, 1935. The Circuit Court of Appeals for the Eighth Circuit has filed no opinion.

II.

Statement and Grounds of Jurisdiction.

Jurisdiction of this Court rests on the certificate of the United States Circuit Court of Appeals for the Eighth Circuit, certifying to this Court certain questions concerning which it desired instructions for the proper decision of the cause, pursuant to Section 239 of the Judicial Code as amended by the Act of February 13, 1925 (28 U. S. C. 346).

III.

Statement of Case.

It is impossible to state the facts more succinctly than did the Circuit Court of Appeals in its statement.

"The Chicago, Rock Island and Pacific Railway Company is a railroad corporation organized under the laws of Illinois and Iowa, with its principal place of business in Chicago. On June 7, 1933, at 9:55 o'clock A. M., the railroad, desiring to effect a plan of reorganization pursuant to Section 77 of the Bankruptcy Act as amended (11 U. S. C. § 205), filed with the United States District Court for the Northern District of Illinois, Eastern Division, its petition for reorganization under that section. The petition alleged that the railroad was unable to meet its debts as they matured. Upon the filing of the petition, a judge of the court, wherein it was filed, approved it as being properly filed under said Section 77.

"At the time of the filing of the petition (9:55 A. M., June 7, 1933), the railroad had to its credit in a checking account with the Northwestern National Bank and Trust Company of Minneapolis, a national bank, the sum of $36,908.72. At the close of business on that day, the amount to the credit of the railroad in said account was

$45,362.94. The bank on June 7, 1933, owned $100,000.00 par value of First and Refunding Gold Bonds of the railroad. These bonds were not then due and would not by their terms become due until April 1, 1934, and there had been no default upon the bonds in the payment of either principal or interest.

"On June 19, 1933, seven days after it received a copy of the order of the United States District Court for the District of Illinois approving the petition for reorganization filed by the railroad, the bank set off the $45,362.94 which was to the railroad's credit with it at the close of banking hours on the day the petition was filed, against the $100,000.00 of bonds of the railroad owned by the bank by charging the railroad's account with that amount and crediting the same upon the bonds."

In so doing, the bank relied upon Section 68(a) of the Bankruptcy Act (11 U. S. C. § 108) and upon subdivision or paragraph (n) of Section 77 of the Bankruptcy Act (11 U. S. C. § 205). The full text of these provisions will be indicated later.

"The railroad protested the set-off and denied the right of the bank to make it. On June 23, 1933, the bank restored to the account of the railroad the sum of $5,611.32, making the net sum deducted from the account for the purposes of set-off $39,751.62. This restoration was made by the bank because on June 10, 1933, three days after the filing of the petition for reorganization, the balance in the account of the railroad with the bank had been drawn down to $39,751.62 which was the lowest amount standing to the credit of the railroad on the books of the bank between the time of the filing of the petition for reorganization and the time the bank made the set-off. The set-off was made voluntarily by the bank and was not ordered, authorized, approved, or consented to by the court in which the petition for reorganization was filed.

"After trustees were appointed for the railroad pursuant to Section 77, they brought suit in the United States District Court for the District of Minnesota to recover the amount of set-off. That court held that Section 68(a), *supra,* was applicable to proceedings under Section 77, and that the bank was therefore entitled to the set-off; but fixed the amount which the bank was entitled to set off at $36,908.72, being the amount on deposit at 9:55 A. M., June 7, 1933, when the petition for reorganization was filed." (R. 1-3.)

The opinion of the trial court (the United States District Court for the District of Minnesota) is not in this record (11 Fed. Supp. 929). It held in favor of the bank (appellee below). From its decree, the trustees (appellants below) appealed to the Circuit Court of Appeals for the Eighth Circuit, and after argument and submission that court certified the following questions to this court:

IV.

Questions Certified.

Question 1. Does the right of set-off recognized by Section 68(a) of the Bankruptcy Act apply to reorganization proceedings under Section 77 of that Act?

Question 2. If the first question be answered in the affirmative, can a bank which owns the unmatured bonds of a railroad corporation set off a deposit account of the railroad with the bank against the bonds, upon the filing by the railroad of a petition for reorganization under Section 77 of the Bankruptcy Act, alleging that the railroad is unable to meet its debts as they mature?

Question 3. If the first and second questions be answered in the affirmative, may the United States District Court, for the District of Minnesota, in the suit by

the trustees of the railroad's estate to recover the amount deducted from the account of the railroad by the bank under the claimed right of set-off, recognize and establish as a proper set-off by the bank one which was not made until after the filing of the petition for reorganization and which has never been ordered, authorized, approved, or consented to by the court in which that petition was filed and approved?

V.

SUMMARY OF ARGUMENT.

A.

Section 68 is inconsistent with Section 77 and hence is inapplicable to a proceeding under it.

Question 1. Section 68 is part of the old Bankruptcy Act which contemplated a complete liquidation. Section 77 contemplates the converse,—a readjustment of the capital structure of a railway company which must be kept in operation pending reorganization. To permit set-off in a proceeding under Section 77 might well and probably would prevent the attainment of the very purpose of the section. If set-off were permitted a railway company entering into a reorganization proceeding might find itself seriously embarrassed for available cash; to permit set-off is to countenance during reorganization the enforcement of debts by certain creditors to the possible obstruction and hindrance of a reorganization plan. To permit property to be withdrawn from the plan by the act of an outside party could well prevent the accomplishment of any reorganization.

The effect of Section 77 is to vest in the bankruptcy court exclusive jurisdiction of the property of the debtor wherever located; claims against that property can be

dealt with only by the method and under the procedure prescribed by Section 77. This involves a reorganization plan which may alter or modify the rights of creditors, secured and unsecured; the determination by the Interstate Commerce Commission and by the bankruptcy court of what treatment shall be given to each class of creditors. No other court can pass upon these questions.

The sole purpose of Section 77(n) is that the approval of the petition should operate as a writ of sequestration and injunction against creditors. Section 68 is therefore inconsistent with 77 (c, d, e, f and g) in that it would permit unequal treatment of the members of the various classes of creditors, and is inconsistent with 77(j) in that it would permit the enforcement of a claim not recognized by the reorganization plan. It is also inconsistent with 77(c) providing for the operation of the properties during reorganization. If the bank has superior equities because of its claimed right of set-off, these equities may be dealt with only under the plan.

B.

Since the railway's bonds were not due or in default and the railway was not insolvent (but was, as alleged in its reorganization petition, merely "unable to meet its debts as they mature") the unmatured bonds cannot be set off against the bank balance.

Question 2. The general rule is that an unmatured debt cannot be used as a set-off except in the event of insolvency. The railway was not insolvent, hence the set-off cannot be permitted. The rule that an unmatured debt can be set off in a bankruptcy proper is applicable only because an ordinary bankrupt must be insolvent. If Section 68 may ever apply to a proceeding under Sec-

tion 77 it can only be where the railway is in fact insolvent. It is wholly inapplicable where the railway is merely unable to meet its debts as they mature. To hold otherwise would be to accelerate every debt and make a reorganization impossible.

C.

Since the United States District Court for the Northern District of Illinois (the court administering the reorganization proceeding) had never ordered, authorized, approved or consented to the attempted set-off, the trial court below (the District Court for the District of Minnesota) was without authority to allow or recognize it.

Question 3. The only court which could permit or authorize the right of set-off was the United States District Court for the Northern District of Illinois, the court of administration. A set-off cannot be permitted or recognized by any other court in the absence of the approval or consent of the court of administration.

VI.

ARGUMENT.

A.

Question 1. Does the right of set-off recognized by Section 68(a) of the Bankruptcy Act apply to reorganization proceedings under Section 77 of that Act?

Section 68 of the Bankruptcy Act (11 U. S. C. 108) reads as follows:

> "(*a*) In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid.
>
> "(*b*) A set-off or counterclaim shall not be allowed in favor of any debtor of the bankrupt which (1) is not provable against the estate; or (2) was purchased by or transferred to him after the filing of the petition, or within four months before such filing, with a view to such use and with knowledge or notice that such bankrupt was insolvent, or had committed an act of bankruptcy."

Paragraph (n) of Section 77 of the Bankruptcy Act (Act of Congress of March 3, 1933), reads as follows:

> "In proceedings under this section and *consistent with the provisions thereof,* the jurisdiction and powers of the court, the duties of the debtor and the rights and liabilities of creditors, and of all persons with respect to the debtor and his property, shall be the same as if a voluntary petition for adjudication had been filed and a decree of adjudication had been entered on the day when the debtor's petition was filed."

Note: Italics supplied throughout.

If, therefore, Section 68 is inconsistent with the other provisions of Section 77, it is not applicable to this case and no set-off can be permitted.

To determine whether such inconsistency exists, it is necessary not only to examine the text of Section 77 itself, but heed must likewise be given to the conditions existing at the time of its passage and the object and purpose of Congress in passing it.

At that time, as a result of the depression and the consequent loss of revenue, the railroads of the country generally were unable to meet their fixed charges and in practically all instances were operating at a loss. In many instances, they were unable to pay their current debts. Since they were public service corporations, forced liquidation was not to be thought of, and bankruptcy in the ordinary sense was, in any event, forbidden by existing law.

There was only one remedy, an equity receivership. This court in *Duparquet, Huot & Moneuse Company* v. *Evans,* — U. S. —, 56 Supreme Court, 412, filed February 3, 1936, pointed out many of the "abuses" and "defects" in an equity receivership, and what this court said in that case as to the reasons for the enactment of Section 77B is equally applicable to the railroad situation and to Section 77.

Congress sought three things by this legislation:

(1) That the railway's properties should not be liquidated, but that the capital structure should be readjusted and the properties eventually returned to their owners.

(2) That all creditors be stayed in the enforcement of their debts pending the reorganization.

(3) That during the period of reorganization the railway's properties should be continuously operated (subdivision (c)).

As we shall point out, permitting a set-off might prevent either in whole or in part the attainment of all three objectives.

As to the terms of Section 77 itself, no better statement of its substance can be made than by quoting the language of this court in *Continental Illinois National Bank* v. *C., R. I. & P. Ry. Co.*, 294 U. S. 648, involving the reorganization proceedings of this same railroad:

> "By the Act of March 3, 1933, c. 204, 47 Stat. 1467, original jurisdiction, in addition to that theretofore exercised in voluntary and involuntary proceedings to adjudge persons bankrupt, was conferred upon courts of bankruptcy 'in proceedings for the relief of debtors,' as provided in Sections 74, 75 and 77 of the act. We are here concerned only with Section 77. That section contains provisions for the reorganization of railroads engaged in interstate commerce. It permits any railroad corporation which is insolvent or unable to meet its debts as they mature to effect a plan of reorganization.
>
> "It provides for the filing of a petition by the railroad corporation in a court designated by the act. If the petition be approved, the court, during the pendency of the proceedings, is given exclusive jurisdiction of the debtor and its property wherever located. The act requires that the railroad corporation shall be referred to in the proceedings as a 'debtor,' and permits any corporation, the majority of the capital stock of which is owned, or substantially all of whose properties are operated, by the debtor under lease or operating agreement, also to file a petition in the same proceeding stating that it is insolvent or unable to meet its debts as they mature and that it desires to effect a plan of reorganization in connection with the plan of the original debtor.
>
> "Other provisions of the section direct that a plan of reorganization shall include a proposal to modify or alter the rights of creditors generally or of any class of them, secured or unsecured, either

through the issuance of new securities or otherwise; that it shall provide adequate means for its execution; that the term 'creditor' includes 'all holders of claims, interests, or securities of whatever character against the debtor or its property'; and that, if the plan is not proposed or accepted or confirmed within a reasonable time to be fixed by the judge, he may dismiss the proceeding.

"Before acceptance of any plan, the Interstate Commerce Commission is directed to hold a public hearing, following which it shall render a report recommending a plan which 'will, in its opinion, be equitable, will not discriminate unfairly in favor of any class of creditors or stockholders, will be financially advisable * * * and will be compatible with the public interest.' The commission is required to state fully the reasons for its conclusions. The plan is then to be submitted to the creditors and stockholders of the debtor for acceptance or rejection. No plan may be finally approved by the commission until it has been accepted in writing by or on behalf of creditors holding two-thirds in amount of the claims of each class affected by the plan, and by or on behalf of stockholders holding two-thirds of the stock of each class.

"Upon approval by the commission, the judge, after hearing, shall confirm the plan if satisfied, among other things, that the plan affords adequate protection for the realization by creditors of the value of their securities, liens and claims in one of the ways pointed out by the section. Upon confirmation of the plan, it is to be binding not only upon corporation and all stockholders and creditors generally, but upon all secured creditors of each class of which two-thirds in amount shall have accepted the plan."

Subdivision (h) of the Act specifically provides:

"The confirmation of the plan shall discharge the debtor from its debts except as provided in the plan."

Subdivision (n) has already been quoted.

For the full text of Section 77 as originally passed, see Appendix, pages 39 to 56, inclusive.[1]

There is a wide gulf between the purposes of a proceeding under the old act and one under Section 77.

The result sought to be accomplished by the old act was to strip the debtor of his property and divide it, pro rata, among his creditors. The result sought by Section 77 is the direct antithesis. It does not contemplate depriving the debtor of his property, but permits him to retain it and reorganize his debts and capital structure. The old bankruptcy proceeding resulted in commercial death; a reorganization under Section 77 results in commercial life.

This court expressly so held in the *Continental Bank* case, saying:

> "But a proceeding under Section 77 is not an ordinary proceeding in bankruptcy. It is a special proceeding which seeks only to bring about a reorganization if a satisfactory plan to that end can be devised."

Although Section 77 clearly contemplates (1) that the debtor shall retain its property, both during and after the reorganization, and (2) that its debts, secured and unsecured, shall be readjusted, the bank contends and the trial court held that under the theory of a set-off under Section 68 the bank might take the railway's property from it and from the court, and with that property pay the debts owed by the debtor in full without any readjustment. A more glaring example of forced liqui-

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[1] Section 77 as originally enacted was amended by the Act of Congress of August 27, 1935, but in particulars not important here. Subdivision (n) of the original section has become subdivision (l) of the amended Section 77. However, this case is to be governed by the original section, since subdivision (s) of the amended section reads:

> "* * * the enactment of this amendatory section shall not invalidate any action taken before its effective date, pursuant to this section as it existed prior to this amendatory section."

dation which Congress sought to avoid and thought that it had avoided can hardly be imagined. To construe Section 77 so as to permit this would be to hold that it wholly fails to accomplish what was intended, and that the entire working capital of a railroad may be dissipated upon the filing of a reorganization petition. That this is not a mere fanciful danger is apparent when we bear in mind the third purpose of the Act already referred to, *i. e.,* that there shall be continued operation of the railway's properties during reorganization.

This is illustrated by the fact that at the date of the petition the railway company had deposits in perhaps fifty banks, scattered throughout the fourteen states in which its system operates. The figures are not in the record, but the court must recognize that in the daily transactions of collecting cash for freight charges, depositing this cash in the local banks for remittance to central banks, a very large sum of money is involved. If all these banks had been bondholders or security holders of the railway company, and all had attempted to set off the deposits against their bonds, the railway company in the hands of the court would have found itself stripped of cash, unable to meet pay rolls, unable to purchase fuel,—unable to operate. In fact, this very situation prevailed in the case of a smaller company, the St. Louis Southwestern, which filed a petition for reorganization on December 12, 1935, in the Eastern District of Missouri. At the same time that the reorganization petition was filed, a separate petition accompanied it, representing that certain moneys of the railroad were on deposit with a St. Louis bank, which also held the notes of the railway company; that, although the right of set-off had been expressly waived by the bank an attempt to set off the deposits against the notes would embarrass the railway company in the operation of the property, and thereupon the court enjoined the bank

from applying the deposits against its notes (see Petition and Order No. 2, St. L. S. W. bankruptcy proceedings).

Such a result is clearly denounced by the reasoning of this court in the *Continental Bank* case, where this court upheld the right of the district court to enjoin the foreclosure of collateral during the pendency of the reorganization, pointing out that unless such foreclosures were restrained, a reorganization was not possible.

The reason for including the right of set-off in the scheme of bankruptcy under the general bankruptcy law and excluding it from a reorganization proceeding under Section 77 is obvious.

A right of set-off was fairly workable in a scheme which contemplated stripping the debtor of his property and dividing it among creditors, because the only question in such a proceeding was among whom and in what proportions were the assets to be divided. However, even in a bankruptcy proper it was a discordant note, because, while equal division among creditors was the principle upon which the bankruptcy law rested (*Hitchcock* v. *Rollo,* Fed. Cas. 6535, cited with approval in *Cumberland Glass Company* v. *DeWitt,* 237 U. S. 447), yet Section 68, allowing a set-off, in fact, created a preference, although one which this court concluded had to be tolerated when within the literal terms of the section.

New York County National Bank v. *Massey,* 192 U. S. 138.

Studley v. *Boylston National Bank,* 229 U. S. 523.

But to apply Section 68 to a reorganization under Section 77 in which the properties are not to be distributed, but are to be retained and eventually returned to the debtor well could, and, as we have demonstrated, very likely would, entirely prevent the accomplishment of the purpose for which the Act was passed.

Upon the approval of the petition the holder of securities is immediately brought within the operation of the reorganization proceeding. In order to make a start upon the plan two things must be determined: *first,* the nature and amount of claims and securities outstanding, and *second,* the nature and amount of the assets of the trust estate. If either of these elements may be changed during the effort to work out a plan of reorganization, the consummation of any plan will necessarily be impeded, or even prevented. To hold that any security holder may interfere with this process by appropriating all or any part of the assets of the trust estate to the payment of his claim, independently of the plan of reorganization, and set up for himself a special status quite different from the provisions provided by the plan, is unthinkable. A maneuver of that sort would be inconsistent with both the letter and purpose of Section 77.

The rights of creditors become static and unchangeable upon approval of the petition by the court. Thereafter they may be altered only by the plan of reorganization. All suits are stayed, and no mortgages, liens, or claims, prior or preferred, can be realized upon, except at the end of the proceeding, and then only according to the provisions of the plan. Why should the remedial right of set-off be made an exception to this general scheme?

The first and immediate effect of the court's approval of the petition filed under Section 77 is to vest in the court "*exclusive* jurisdiction of the debtor and its property *wherever located.*" This, of course, includes all bank deposits such as the bank's debt in this case. The bank had no right to seize any part of the property of the railway company; all of that property was under the exclusive jurisdiction of the bankruptcy court, and the

court is now, through its trustees, asking the bank to surrender that portion which the bank has seized.

From the moment of the approval of the petition, the rights of the bank as a claimant or a creditor could be dealt with only through the reorganization plan when finally passed upon by the Interstate Commerce Commission representing the public, and by the bankruptcy court. Certainly it was never intended by Section 77 to leave a creditor free, as the bank claims it is free in this case, to apply to his unmatured bonds a debt due the railway company; arbitrarily to take into his own hands the matter of payment of those bonds, without waiting for the commission or the court to determine what is fair and equitable treatment for the bondholders as a class. If this set-off be permitted and the action of the bank be upheld, then the bank has paid off in full, thirty-six, out of its one hundred, First and Refunding Bonds, and may file a claim in the bankruptcy court upon the remaining sixty-four bonds; or may, without notice to anyone, sell the remaining sixty-four bonds on the open market, as it bought them,—and sit back satisfied. Other bondholders, not so fortunate as to have held bank deposits of the railway company, will have to accept for their bonds such securities as may be allotted to them under the plan.

Therefore, it is clear that Section 68, purporting to allow a set-off in bankruptcies generally, is not consistent with those provisions of Section 77 which require equality of treatment for all of each class of creditors. Specifically as applied to this case, it would permit the bank a preference over its fellow First and Refunding bondholders, which is emphatically denounced by Section 77. See subdivisions (c), paragraph 5, (d), (e), (f), and (g), paragraph 1, which provide for the division of all claimants into classes and necessarily require

that all members of each class be accorded like treatment.[2]

Section 68 is likewise inconsistent with subdivision (j) which expressly provides that upon the confirmation of the reorganization plan the property of the debtor shall be free from all claims of every character, except as specified in the plan. Section 68 allowing a set-off is, therefore, utterly inconsistent with subdivision (j), in that it purports to recognize a claim against property which is not recognized by the reorganization plan.

It should be borne in mind that what this case deals with is the right to the present possession of the funds in question. It does not seek to adjudicate the rights of the bank in the property of the debtor as they shall be established and recognized by the reorganization plan. Therefore, the claim advanced by the bank that awarding this fund to the trustees would forever deprive the bank of any superior equities it might have over the other First and Refunding bondholders, and that the *Continental Bank* case is to be distinguished on that ground is without foundation even if the bank is right in its claim that it has any such superior equities. But if such superior equities over the other First and Refunding bondholders do exist (which we emphatically deny), these equities must be determined and made effective, not by the bank itself in its own banking house, or by the District Court of Minnesota in this case, but by the District Court of Illinois which is administering this trust estate, and the Interstate Commerce Commission. These equities cannot be made effective by permitting the bank arbitrarily to withdraw assets from the operation of the plan, but can be recognized only by the

[2] While there is no specific provision that each member of each class must be treated alike, that conclusion necessarily follows from subdivision (c), paragraph 5, requiring the division of creditors into classes, and the subsequent subdivisions referring repeatedly to classes.

"Class.—A group of individuals ranked together * * * as having the same status." (Webster's Dictionary.)

court administering the trust estate by its confirmation of the plan.

Cumberland Glass Company v. *De Witt*, 237 U. S. 447.

It is the court of administration and not the bank which must determine the property on which the plan will operate.

But the bank argues that such construction deprives subdivision (n), so far as it relates to the rights of creditors, of any substantial meaning.

The view of the trial court is indicated by the following excerpt from its memorandum:

> "* * * But we are confronted with the unambiguous language contained in subsection (n) of Section 77 to the effect that the rights and liabilities of creditors with respect to the debtor and his property shall be the same as if a voluntary petition had been filed and the debtor adjudicated a bankrupt. It is fair to assume that, in so far as it may be consonant with the general provisions of Section 77, Congress intended by subsection (n) to fix the status of the parties as to their rights and liabilities with reference to liens, preferences, etc., as would have resulted in the event there had been an adjudication. Obviously, there are many rights of creditors under the Bankruptcy Act that do not arise in a reorganization proceeding, and a recognition of which would be inconsistent with the objects of Section 77, but it must be also recognized that there are many rights of creditors that are necessarily preserved in proceedings under this reorganization act. For instance, the claims of creditors who have received preferences would be governed by the general provisions of the act. Claims entitling to priority would be recognized. The so-called four months rule would apply, and as suggested before, it is difficult to understand any inconsistency between the exercise of the right of

set-off when the reorganization plan is being effected." 11 Fed. Supp. 929, 935.

In this, we submit that the court gave to subdivision (n) a construction far beyond its proper scope. It is clear, we think, that what was intended was no more than that the second purpose above suggested should be accomplished, namely, that the remedies of all creditors should be stayed pending the reorganization.

Subdivision (n) is a "residuary" statute, a catchall. In view of its restrictive application "consistent with the provisions hereof," it could hardly be claimed that subdivision (n) had the effect of reading into Section 77 any provision of the old bankruptcy law covering any phase of the subject covered by Section 77. To illustrate, the old bankruptcy law contains a complete code as to the remedial rights of creditors in such a proceeding, election of trustee, conversion of property into cash, payment of dividends, etc. Obviously, these provisions are inconsistent with Section 77 and do not become a part of it, because in the latter section we find elaborate provisions as to the only remedy a creditor has (whether secured or not and whether occupying a preferential status or not), *i. e.*, to participate in the reorganization plan.

It is, therefore, clear that so far as the remedial rights of creditors in the proceeding are concerned, subdivision (n) is wholly without application. It does not purport to prescribe what a creditor may do in the proceeding for that is fully covered by subdivisions (b), (c), (d), (e), (f), (g), (h), and (j), and those subdivisions provide the only things that he can do. It does not "preserve" any rights because they are all otherwise preserved. But there is no express provision in Section 77 preventing a creditor from levying, attaching, or otherwise impounding a debtor's property after the filing of

the petition. Subdivision (n), therefore, so far as it deals with the rights of creditors, was intended to accomplish just one thing. It was intended, not to prescribe what a creditor could do, but to prescribe what he could not do, *i. e.,* to prevent him from pursuing his usual remedies against the debtor outside the reorganization proceedings.

The trial court, however, by permitting the bank, as the holder of unmatured bonds, to set them off at par against the bank deposits of the railway mistakenly distorted the scheme of Section 77 and the intention of Congress in enacting it. Such a decision allows a creditor, who happens also to be a debtor, and for no other reason, to ignore the reorganization proceeding, jeopardize its progress and consummation, and pay itself off in full to the detriment and disadvantage of other creditors, mortgagees, and lien holders who possess at least equal, if not superior, equities.

The right of set-off, when it exists, though perhaps more than "a procedural convenience" is, at most, a remedial right rather than a substantive right—a mere means of collection. Section 77, in and of itself, prescribes the whole remedy, the only remedial right, which a creditor is entitled to in a proceeding brought under the section, *i. e.,* participation in a reorganization plan and that only.

It is apparent from what has been said that the only purpose which subdivision (n) accomplishes (so far as it deals with the rights of creditors) is that it limits those rights and prevents (as would an ordinary adjudication in bankruptcy) the levying, attaching, or otherwise seizing or impounding the debtor's assets. If subdivision (n) were entirely omitted, every other right of creditors is expressly provided for.

In short, the only purpose of subdivision (n) is to provide that the approval of the petition for reorganization shall during the period of such reorganization also operate as a writ of sequestration and injunction.

A very persuasive case in this connection is a decision under Section 77B, a cognate statute, providing for the reorganization of business corporations. We refer to *Grand Boulevard Investment Co.* v. *Strauss*, 78 Fed. (2d) 180 (Eighth Circuit), which seems absolutely parallel to the case at bar.

In that case, upon default in a real estate mortgage more than four months previous to the filing of a petition under Section 77B, the property was turned over to the possession of the mortgagee, who became therefore a mortgagee in possession. Upon the filing of the petition under Section 77B, the debtor petitioned for an order to be restored to possession. The lower court denied the petition on the ground that it lacked the requisite power. The Eighth Circuit reversed that holding and held that in spite of the fact that the mortgagee had been in possession for more than four months previous to the filing of the reorganization petition and that that court in bankruptcy cases proper had recognized that under such circumstances a mortgagee in possession could be ousted only upon payment of his mortgage, such rule did not apply to a proceeding under Section 77B, and that such mortgagee in possession could be ousted and the property redelivered to the debtor for the purpose of accomplishing a reorganization.

Will the court bear in mind the absolute parallel features of this case and the case at bar?

In the *Grand Boulevard* case, the mortgagee was in possession under a mortgage.

In the case at bar, the bank is in possession under what the trial court terms a "possessory lien," but what

the Eighth Circuit, in the case of *Clearwater County* v. *Pfeffer,* 236 Fed. 183, terms a mere right of set-off, and this court in *Studley* v. *Boylston National Bank, supra,* terms a "banker's lien" or "right to use his claim * * * in satisfaction of what he owes."

In the *Grand Boulevard* case, had the proceeding been an ordinary bankruptcy, the mortgagee could have retained possession and could not have been ousted, but since it was not an ordinary bankruptcy but a reorganization, the right under the old bankruptcy law to retain possession was not preserved, because it could not be preserved if the purposes of Section 77B were to be accomplished.

The same conclusion must be reached in the case at bar, *i. e.,* the so-called "possessory lien" or right of set-off is not preserved under Section 68 in a proceeding under Section 77.

The first question should be answered in the negative.

B.

Question 2. If the first question be answered in the affirmative, can a bank which owns the unmatured bonds of a railroad corporation set off a deposit account of the railroad with the bank against the bonds, upon the filing by the railroad of a petition for reorganization under Section 77 of the Bankruptcy Act, alleging that the railroad is unable to meet its debts as they mature?

That the First and Refunding Bonds were in good standing on June 7, 1933 (they being not yet due and there being no default in interest), is conceded.

In the *Continental Bank* case, this court held (*a*) that the words "bankrupt" and "insolvent" were synonymous, and (*b*) that a railway need not be insolvent to

come under Section 77, that it was enough that it be unable to meet its debts as they mature without any insolvency. The original Bankruptcy Act, Section 1 (U. S. C. Title 11, Chapter 1, Section 1), defines insolvency as follows:

> "(15) A person shall be deemed insolvent within the provisions of this title whenever the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed, or removed, or permitted to be concealed or removed, with intent to defraud, hinder or delay his creditors, shall not, at a fair valuation, be sufficient in amount to pay his debts."

Later (19) in the same section, the word "persons" is defined to include corporations. The railway was not insolvent.

Under these circumstances, the familiar rule applies that an unmatured debt cannot be offset except in the event of the insolvency of the debtor. There is no question of what the general rule is. *Schuler* v. *Israel,* 120 U. S. 506. In *Clearwater County* v. *Pfeffer,* 236 Fed. 183, the Eighth Circuit said:

> "The right of a banker, sometimes loosely styled a lien, to charge up to a depositor without his order, his note or other obligation to pay before it is due is conditioned on the latter's insolvency."

(See also annotations in 25 L. R. A. (N. S.), 393, and 43 A. L. R. 1325, 1328.)

The converse is perhaps true, that if the debtor is insolvent the offset of an unmatured claim is permitted, although in most cases, in addition to insolvency, there were other equities which justified the set-off. This is the rule in the Minnesota state courts.

Stolze v. *Bank of Minnesota,* 67 Minn. 172; 69 N. W. 813.

Sweetser v. *Peoples Bank of Minneapolis,* 69 Minn. 196; 71 N. W. 934.

Wunderlich v. *Merchants National Bank,* 109 Minn. 468; 124 N. W. 223.

Platts v. *Metropolitan National Bank,* 130 Minn. 219; 153 N. W. 514.

The trial court seems to hold that, while this is the general rule, the facts here brought the case within an equitable exception. This is what the court said:

> "Therefore, while evidence is lacking that, marshalling assets against liabilities, the railway company is insolvent, there is a strong showing of insolvency that equity should recognize in support of the defendant's set-off irrespective of the bankruptcy statute." 11 Fed. Supp. 929, 936.

We submit that the bank is no such favorite of the law and has no such special equities as to justify the court in relaxing, in the exercise of its equitable jurisdiction, the general rule of set-off.

We are wholly unable to appreciate either the argument of counsel or the holding of the trial court that the equities in this case are in favor of the bank. On the contrary, it seems too clear for comment that they are strongly against the bank and strongly in favor of the trustees. In *Gray* v. *Rollo,* 18 Wall. 629, this court said:

> "Other instances are given by way of illustration of the principle on which a court of equity will deviate from the strict rule of mutuality, allowing a set-off; all of them based on the idea that the justice of the particular case requires it, and that injustice would result from refusing it; but none of them approaching in likeness to the case before the court. *There is no rule of justice or equity which requires that Gray Brothers should be paid in preference to other creditors of the insurance company, out of the specific assets represented by the notes of Gray and Gaylord.*"

There is nothing whatever in either the letter or spirit of Section 77 to warrant a conclusion that an allegation of temporary financial embarrassment would accelerate an unmatured debt and permit creditors, by means of set-off, to dissipate the very estate upon which the reorganization sought by Section 77 must of necessity be constructed. It cannot have been the intention that an attempt by a railway company to rehabilitate itself under Section 77 should accelerate every debt. Such a holding would completely nullify the law.

The cases cited by the trial court do not justify the conclusion reached. 11 Fed. Supp. 929, 936. These cases merely hold that inability to meet debts as they mature is ground for the appointment of a receiver. This is, of course, conceded to be the true equity rule. Section 77 merely extends this rule and makes it applicable to a proceeding under it.

All that the railway has done here is to admit a temporary inability to pay its debts as they mature and ask that there be a reorganization of its capital structure. The trial court seems to hold that this petition of itself does not mature its debts because of lack of actual insolvency, but that the filing of the petition affords evidence of the actual financial condition and that that financial condition, irrespective of the proceeding under Section 77, is what matures the debt here for set-off purposes. Possibly the fact of actual insolvency without any adjudication is sufficient to so mature debts under proper circumstances (*Wunderlich* v. *Merchants National Bank,* 109 Minn. 468; 124 N. W. 223), but we have never heard it suggested that a shortage of ready cash resulted in this. We have found no case so holding, nor has the bank cited any such authority.

The bank, however, asserts that, while the question of solvency may be material in an equity receivership,

it is unimportant here, because this is a bankruptcy proceeding (admittedly in a bankruptcy proper all debts become immediately due) and since under Section 63(a) of the Bankruptcy Act (11 U. S. C. 103) any claim whether due or not may be proved (*Carr* v. *Hamilton*, 129 U. S. 252), it may be used as a set-off under Section 68 regardless of insolvency. This argument is unsound for two reasons:

(1) It overlooks the fact that the basis and reason for permitting an unmatured claim to be used as a set-off in a bankruptcy proper rests upon the theory that the debtor is, in fact, insolvent, otherwise he would not be in bankruptcy. Hence, to say that an unmatured claim may be used as a set-off in a bankruptcy proper is merely to say in another way that an unmatured claim may be used as a set-off in a case of insolvency. But it does not follow that an unmatured claim can be used as a set-off in this "special proceeding," because here there is no insolvency.

This would seem conclusive but for one argument advanced by the bank to the effect that our premise is wrong and that a debtor need not actually be insolvent to take advantage of the old bankruptcy law as a voluntary bankrupt. This suggestion has enough support in the decisions of the lower courts to require notice.

Such a rule seems to have been laid down by several of the lower courts.

In re Montevallo Mining Company, 294 Fed. 171 (5th Circuit).

People's National Bank of Plymouth, Ohio v. *Foltz*, 25 Fed. (2d) 295 (6th Circuit).

In re Ann Arbor Machine Company, 278 Fed. 749 (Eastern District of Michigan).

In re Lachenmaier, 203 Fed. 32 (7th Circuit).

In re The C., R. I. & P. Ry. Co., 72 Fed. (2d) 443.

In re Hargadine McKittrick Dry Goods Company, 239 Fed. 155 (D. C. Missouri).

In re Dressler Producing Corporation, 262 Fed. 257 (2nd Circuit).

1, Remington on Bankruptcy, Fourth Edition, Section 48.

This court has never so held, although *Hanover National Bank* v. *Moyses,* 186 U. S. 181, is sometimes cited as an authority for the proposition. However, when the Moyses case is examined carefully, it is apparent that all this court there determined (and by way of argument only) was that when a debtor alleged in his voluntary petition that he was insolvent, it was not a traversable allegation and no issue of fact could be raised as to its truth. This is the language of the court:

> "The act provides that 'any person who owes debts, except a corporation, shall be entitled to the benefits of this act as a voluntary bankrupt,' [3] (Section 4a), and that 'upon the filing of a voluntary petition the judge shall hear the petition and make the adjudication or dismiss the petition.' Section 18g. With the petition he must file schedules of his property, and 'of his creditors, showing their residences, if known, if unknown, that fact to be stated.' Section 7, subd. 8. The schedules must be verified, and the petition must state that 'petitioner owes debts which he is unable to pay in full,' and 'that he is willing to surrender all his property for the benefit of his creditors, except such as is exempt by law.' This establishes those facts so far as a decree of bankruptcy is concerned, and he has committed an act of bankruptcy in filing the petition. These are not issuable facts, and notice is unnecessary, unless dismissal is sought, when notice is required. Section 59g.

[3] The present Act, Section 4 (11 U. S. C. 22) reads:

"Any person, except a municipal, railroad, insurance, banking corporation, or a building and loan association, shall be entitled, etc."

> "As Judge Lowell said: 'He may be, in fact, fraudulent, and able and unwilling to pay his debts; but the law takes him at his word, and makes effectual provision, not only by civil but even by criminal process to effectuate his alleged intent of giving up all his property.' *In re Fowler,* 1 Lowell, 161."

If an involuntary bankrupt admits insolvency in his answer, there is nothing to try. It is merely the application of the familiar rule that what is admitted need not be proved. But a judgment based on an admission is just as binding as a judgment after a bitterly controverted trial. In this sense it is, of course, true that a solvent person may be adjudged a voluntary bankrupt under the old law if he alleges (contrary to the fact) that he is insolvent, just as a solvent person may be adjudged an involuntary bankrupt if he admits in his answer (contrary to the fact) that he is insolvent.

(2) As this court held in the *Continental Bank* case, there is a clear-cut distinction between insolvency or bankruptcy on the one hand, and inability "to meet its debts as they mature" on the other (672).

Section 77 allows a railway to invoke the jurisdiction of the court upon either of two separate grounds—insolvency or inability to meet debts as they mature. These terms, as the court says, are in the alternative. They are not the same thing, and the second obviously means something less than the former. If subdivision (n) should not mean merely that the approval of a petition for reorganization shall operate as a writ of sequestration and injunction, as we maintain, but means that the rights of creditors, "in proceedings under this section and *consistent with the provisions* thereof," shall be the same as if a voluntary petition for adjudication had been filed and a decree of adjudication entered, then the proper construction of subdivision (n) must be this: The provisions of the old bankruptcy law, applicable to

insolvency, will apply when the petition alleges insolvency as the ground of jurisdiction but no provision of the old Bankruptcy Act, which is applicable *only* to insolvency, will apply when the ground of jurisdiction is *not insolvency* but "obviously something less." Subdivision (n) would require and work an inconsistency should it operate to convert one of the alternative grounds of jurisdiction,—inability to pay debts,—into the other—insolvency. Such a construction of subdivision (n) would, therefore, be inconsistent with the plain provisions of subdivision (a).

If subdivision (n) means that the law applicable to an insolvent bankrupt shall apply with equal force to a corporation which "although unable to pay promptly, may be able to pay if time to do so be sufficiently extended" and which is by no means insolvent but merely temporarily financially embarrassed, then the filing of a petition for reorganization *ipso facto* immediately accelerates and matures every indebtedness, including mortgages, bonds, equipment trusts, notes, and every other type of obligation outstanding at the time of the filing of the petition.

It is a matter of common knowledge that certain railway companies undergoing reorganization have, with the permission of the court, paid certain interest on their long term issues with the very purpose of preventing an acceleration of their maturities and a consequent default, so that ultimately it might facilitate the reorganization. Yet, if subdivision (n) is to be construed as the trial court construed it, this accomplished nothing, and these bond issues immediately matured and were in default. It is inconceivable that Congress intended any such result. Section 77, then, instead of being an invitation to reorganize, would be a deterrent. The penalty of an unsuccessful attempt at reorganization would be too severe, because the result would be

to mature debts immediately which otherwise would not have been due for many years. Certainly, Congress did not intend to metamorphose a solvent railway corporation into a hopeless insolvent merely because it attempts to reorganize under Section 77.

It is significant that out of the hundreds of railroad receiverships[4] in this country during the past sixty years[4] there is not one reported case where it has been claimed that upon a railway's passing into the hands of a receiver, the bank had the right to set off unmatured railway bonds against its bank account; yet, if the set-off can be effected here, because of mere inability to meet debts as they mature, it could have been in any equity receivership, because Section 68 adopts the equity rule of set-off. (*Sawyer* v. *Hoag,* 17 Wall. 610; *Cumberland Glass Company* v. *De Witt, supra; Studley* v. *Boylston National Bank, supra.*) . It is impossible that the identical situation which exists here has not existed in equity receiverships hundreds of times. It is, therefore, clear that the bar, at least, has always taken the view that under such circumstances the right of set-off did not exist. This fact has great significance. (*Cf. Grosjean* v. *American Press Company, Inc.,* — U. S. —, 56 Supreme Court 444, filed February 10, 1936.) An affirmative answer to Question 2 would mean that a proceeding under Section 77 would be less conducive to a reorganization than an equity receivership.

The second question should be answered in the negative.

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[4] From 1876 to 1935, inclusive, there were 981 receiverships of steam railroads with a total mileage of 334,700 miles, and with a total capitalization (bonds and stocks) of over $16,000,000,000, Railway Age of January 4, 1936 (annual statistical number), page 47, table IX, "Summary of Railroad Receiverships and Foreclosure Sales, 1876 to 1935."

C.

Question 3. If the first and second questions be answered in the affirmative, may the United States District Court, for the district of Minnesota, in the suit by the trustees of the railroad's estate to recover the amount deducted from the account of the railroad by the bank under the claimed right of set-off, recognize and establish as a proper set-off by the bank one which was not made until after the filing of the petition for reorganization and which has never been ordered, authorized, approved, or consented to by the court in which that petition was filed and approved?

As the court below stated in its certificate certifying certain specific questions "the set-off * * * was not ordered, authorized, approved, or consented to by the court in which the petition for a reorganization was filed." (R. 3.)

Even in an ordinary bankruptcy a set-off under Section 68 is not self-executing, nor capable of execution by the parties, but must be approved and acted upon by the court of administration. This is clear from the use of the words "the account shall be stated" and "a set-off shall not be *allowed* in favor of a debtor."

However, this court in *Cumberland Glass Company* v. *De Witt,* 237 U. S. 447, settled the question. In that case, De Witt sued the Glass Company for maliciously inducing a breach of contract by one of its customers. He recovered a judgment in the state courts.

Among the defenses pleaded by the Glass Company was *res judicata,* and the adjudication relied upon consisted of this: previously De Witt had been adjudged a bankrupt; he had scheduled among his liabilities an indebtedness due to the Glass Company and among his

assets the same claim for which he was bringing suit. Conceding that it might have been done if proper action had been taken, nevertheless, the court administering the bankruptcy had not been asked to and had not set off the liability of the Glass Company to De Witt (scheduled as an asset) against the liability of De Witt to the Glass Company (scheduled as a liability).

Later a composition agreement was approved by a majority of creditors (although the Glass Company did not join in such approval) and made effective by the court. The Glass Company received and accepted its dividends under the composition, and no claim was made that the composition was not binding upon it.

It was urged in this court by the Glass Company that De Witt's claim against it had automatically been offset against its claim against De Witt, and, hence, that the composition operated to extinguish the net balance in favor of the Glass Company, and that the claim of De Witt against the Glass Company was extinguished by offsetting it against the Glass Company's claim against him.

De Witt, however, urged that since the court had not ordered or authorized the offset there had been no offset, and, hence, that while the claim of the Glass Company was extinguished by the composition, the claim of De Witt against the Glass Company was unaffected by it, but was restored to him, unaffected by the bankruptcy proceedings.

In discussing the provisions of Section 68(a) the court said:

> "The object of this provision is to permit, as its terms declare, the statement of the account between the bankrupt and the creditor, with a view to the application of the doctrine of set-off between mutual debts and credits. The provision is permissive rather than mandatory, and does not enlarge the doctrine of set-off, and cannot be invoked in cases

where the general principles of set-off would not justify it. Black, Bankr. 544; *Re Kyte*, 182 Fed. 166. *The matter is placed within the control of the bankruptcy court, which exercises its discretion in these cases upon the general principles of equity. Hitchcock v. Rollo*, 3 Biss. 276, Fed. Cas. No. 6,535. The section was taken almost literally from Sec. 20 of the act of 1867 (14 Stat. at L. 526, chap. 176). In *Sawyer* v. *Hoag*, 17 Wall. 610, 21 L. ed. 731, in considering that section of the act of 1867, this court said: 'This section was not intended to enlarge the doctrine of set-off or to enable a party to make a set-off in cases where the principles of legal or equitable set-off did not previously authorize it.' While the operation of this privilege of set-off has the effect to pay one creditor more than another, it is a provision based upon the generally recognized right of mutual debtors, which has been enacted as part of the bankruptcy act, and when relied upon should be enforced by the court. *New York County Nat. Bank* v. *Massey*, 192 U. S. 138, 48 L. ed. 380, 24 Sup. Ct. Rep. 199.

"It hence appears that the object of this section was to give the district court the right to apply the established principles of set-off to mutual credits, *when its action was invoked for that purpose.*

"The language of the act indicates the necessity of action by the court, for the statute provides that *'the account shall be stated'* and the one debt set off against the other, and the balance only allowed to be paid. This statute recognizes the nature of set-off, as established in common law and equitable procedure.

* * *

"In the present case, the Glass Company made no attempt to invoke the action of the district court in the bankruptcy proceedings. If it had the right to do so, it did not seek the action of the bankruptcy court to state the account or make the settlement, and we have been unable to find any case, and none is called to our attention, in which it is held that

simply because of the bankruptcy proceedings and the filing of the schedule and proofs of debt the set-off is automatically made between parties holding mutual credits. On the other hand, as the section indicates, and so far as we know, all the authorities hold, this section is not self-executing, but its benefit is to be had upon the action of the district court only when it is properly invoked, and that court has the primary duty of determining for itself whether there are 'mutual debts or credits' that should be set off one against the other according to the true intent and meaning of the bankruptcy act.

* * *

"There is lacking in this case the first and most essential element of *res judicata; namely, former* judgment of a competent court, adjudicating the matter in controversy between the parties, yet *res judicata* in the bankruptcy court by the former proceedings was the sole contention of Federal right here put in issue."

It is also important to notice the language of the dissenting opinion written by the Chief Justice, in which three Justices concurred. Although the dissent was as to the conclusion, the language of the dissenting opinion with reference to Section 68(a) and the forum of its application is in accord with the majority opinion, and absolutely controlling here.

"(a) Did the bankrupt law confer upon the Glass Company the right to have the scheduled claim against it for damages when liquidated set off against the debt which it proved for the price of the goods by it sold? That the comprehensive provisions of Secs. 68a and b of the bankrupt law relating to set-offs and counterclaims are coincident with the scope of the act, and therefore give the power *to the bankruptcy court to determine* whether or not the right of set-off exists as between all and any claims required to be surrendered as assets of

the estate, on the one hand, and all debts proved against the estate, on the other, is, I submit, *self-evident; for to hold to the contrary would deprive the bankruptcy court of authority to exert its powers over matters to which its jurisdiction in the nature of things must extend.* It is equally indisputable, as long since settled by this court, that in exerting its powers when occasion requires it as between all or any of the items of the active or passive side of the bankrupt estate, it is the duty of the court of bankruptcy not merely to determine the right of set-off by strict common-law principles, but to govern the subject by the broad doctrines of set-off as administered by courts of equity. *Sawyer* v. *Hoag,* 17 Wall. 610, 21 L. ed. 731. It is also clear that in order to additionally accomplish the public purposes just stated, the bankrupt act in some respects narrows the operation of set-off, since it prevents it from automatically operating by subjecting it in every case to judicial control. Under these principles there is no reason for doubting that the proved claim of the Glass Company against the bankrupt estate was subject under the law to be set off against the scheduled claim held by the estate against the Glass Company whether the latter claim was so liquidated as to enable the set-off to be made, *and that the duty of accomplishing this essential result by the terms of the statute primarily rested upon the bankruptcy court.* I say the terms of the statute, since it in express words commands that the set-off for which it provides shall be accomplished, to the end that a distribution shall be made not upon the original claims, but upon the balances resulting from carrying out the commands of the statute as to set-off."

Following this case, this court in *Isaacs* v. *Hobbs Tie & Timber Company,* 282 U. S. 734, in discussing the question of whether there might be a foreclosure of a real estate mortgage on land in another state without the consent of the bankruptcy court, said:

"Upon adjudication, title to the bankrupt's property vests in the trustee with actual or constructive possession, and is placed in the custody of the bankruptcy court. *Mueller* v. *Nugent,* 184 U. S. 1, 14. The title and right to possession of all property owned and possessed by the bankrupt vests in the trustee as of the date of the filing of the petition in bankruptcy, no matter whether situated within or without the district in which the court sits. *Robertson* v. *Howard,* 229 U. S. 254, 259-260; *Wells* v. *Sharp,* 208 Fed. 393; *Galbraith* v. *Robson-Hilliard Grocery Co.,* 216 Fed. 842. It follows that the bankruptcy court has exclusive jurisdiction to deal with the property of the bankrupt estate. It may order a sale of real estate lying outside the district. *Robertson* v. *Howard, supra; In re Wilka,* 131 Fed. 1004. When this jurisdiction has attached the court's possession cannot be affected by actions brought in other courts. *White* v. *Schloerb,* 178 U. S. 542; *Murphy* v. *Hofman Co.,* 211 U. S. 562; *Dayton* v. *Stanard,* 241 U. S. 588. This is but an application of the well recognized rule that when a court of competent jurisdiction takes possession of property through its officers, this withdraws the property from the jurisdiction of all other courts which, though of concurrent jurisdiction, may not disturb that possession; and that the court originally acquiring jurisdiction is competent to hear and determine all questions respecting title, possession and control of the property. *Murphy* v. *Hofman Co., supra; Wabash R. Co.* v. *Adelbert College,* 208 U. S. 38; *Harkin* v. *Brundage,* 276 U. S. 36. Thus, while valid liens existing at the time of the commencement of a bankruptcy proceeding are preserved, *it is solely within the power of a court of bankruptcy to ascertain their validity and amount and to decree the method of their liquidation. Ex parte City Bank of New Orleans,* 3 How. 292; *Houston* v. *City Bank of New Orleans,* 6 How. 486; *Ray* v. *Norseworthy,* 23 Wall. 128; *In re Wilka, supra; Nisbet* v. *Federal Title & T. Co.,* 229 Fed. 644. The exercise of this function necessarily forbids inter-

ference with it by foreclosure proceedings in other courts, which save for the bankruptcy proceeding would be competent to that end. As mortgaged property ordinarily lies within the district in which the bankruptcy court sits, and the mortgagee can consequently be served with its process, the procedure usually followed is for that court to restrain the institution of foreclosure proceedings in any other. Where the land lies outside the limits of the district in which the bankruptcy court sits, ancillary proceedings may be instituted in the district court of the United States for the district in which the land is, and an injunction against foreclosure issued by the court of ancillary jurisdiction. *In re Patterson Lumber Company,* 228 Fed. 916; 247 Fed. 578. Compare *Security Mortgage Co.* v. *Powers,* 278 U. S. 149. Such injunctions are granted solely for the reason that the court in which foreclosure proceedings are instituted is without jurisdiction, after adjudication of bankruptcy, to deal with the land or liens upon it save by consent of the bankruptcy court."

With what greater strength of reasoning does this rule apply to a proceeding under Section 77? This has already been discussed (pages 15-16). When it is borne in mind that from the instant of the filing of the petition the bankruptcy court has *exclusive jurisdiction* of the debtor and its property *wherever located;* that the bank's debt to the railway company is part of this property; that the sole purpose of the section is a plan of reorganization; that this plan must deal with the rights of creditors, secured and unsecured, including the rights of the bank as a creditor; that the terms and provisions of the plan must be passed upon and approved by the Interstate Commerce Commission and by the bankruptcy court; that subdivision (h) provides that the confirmation of the plan shall discharge the debtor from all debts except as provided in the plan; that subdivision (k) pro-

vides that the property shall go back to the debtor free from all claims except those recognized by the plan; and that the only remedy a creditor can possibly have under Section 77 is in and through that plan,—when all these things are considered, it becomes apparent that the rule in a general bankruptcy proceeding that the set-off can be made only by the action of the bankruptcy court is doubly essential in a proceeding under Section 77.

Otherwise, there could never be a reorganization.

The third question, therefore, should be answered in the negative.

Respectfully submitted,

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March 14, 1936.

APPENDIX.

AN ACT.

To amend an Act entitled "An Act to establish a uniform system of bankruptcy throughout the United States," approved July 1, 1898, and Acts amendatory thereof and supplementary thereto.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the Act of July 1, 1898, entitled "An Act to establish a uniform system of bankruptcy throughout the United States," as amended by the Acts of February 5, 1903, June 15, 1906, June 25, 1910, March 2, 1917, January 7, 1922, May 27, 1926, and February 11, 1932, be, and it is hereby, amended by adding thereto a new chapter to read as follows:

"CHAPTER VIII

"PROVISIONS FOR THE RELIEF OF DEBTORS

"SEC. 73. ADDITIONAL JURISDICTION.—In addition to the jurisdiction exercised in voluntary and involuntary proceedings to adjudge persons bankrupt, courts of bankruptcy shall exercise original jurisdiction in proceedings for the relief of debtors, as provided in sections 74, 75 and 77 of this Act.

(Sections 74, 75 and 76 omitted.)

"SEC. 77. REORGANIZATION OF RAILROADS ENGAGED IN INTERSTATE COMMERCE.—(a) Any railroad corporation may file a petition stating that the railroad corporation is insolvent or unable to meet its debts as they mature and that it desires to effect a plan of reorganization. The petition shall be filed with the court in whose territorial jurisdiction the railroad corporation, during the

preceding six months or the greater portion thereof, has had its principal executive or operating office, and a copy of the petition shall at the same time be filed with the Interstate Commerce Commission, hereinafter called the commission: *Provided,* That when any railroad, although engaged in interstate commerce, lies wholly within one State, such proceedings shall be brought in the Federal district court within the state in which the railroad is located. The petition shall be accompanied by payment to the clerk of a filing fee of $100, which shall be in addition to the fees required to be collected by the clerk under other sections of this Act. Upon the filing of such a petition, the judge shall enter an order either approving it as properly filed under this section, if satisfied that such petition complies with this section and has been filed in good faith, or dismissing it if not so satisfied. If the petition is so approved, the court in which such order approving the petition is entered shall, during the pendency of the proceedings under this section and for the purposes thereof, have exclusive jurisdiction of the debtor and its property wherever located. The railroad corporation shall be referred to in the proceedings as a 'debtor.' Any corporation, the majority of the capital stock of which having power to vote for the election of directors is owned, either directly or indirectly through an intervening medium, by any railroad corporation filing a petition as a debtor under this section, or substantially all of whose properties are operated by such a debtor under lease or operating agreement may file, with the court in which such other debtor had filed such a petition, and in the proceeding upon such petition under this section, a petition stating that it is insolvent or unable to meet its debts as they mature and that it desires to effect a plan of reorganization in connection with, or as a part of, the plan of reorganization of such other debtor; and thereupon such court shall

have the same jurisdiction with respect to it, its property and its creditors and stockholders as the court has with respect to such other debtor. Creditors of any railroad corporation having claims or interests aggregating not less than 5 per centum of all the indebtedness of such railroad corporation as shown in the latest annual report which it has filed with the commission at the time when the petition is filed, may, if the railroad corporation has not filed a petition under this section, but subject to first having obtained the approval of the Interstate Commerce Commission, after hearing, upon notice to such railroad corporation, file with the court in which such railroad corporation might file a petition under the provisions of this section, a petition stating that such railroad corporation is insolvent or unable to meet its debts as they mature and that such creditors propose that it shall effect a reorganization; upon such filing of such a petition copies thereof shall be filed with the commission and served by the petitioning creditors forthwith upon the railroad corporation; the railroad corporation shall, within ten days after such service, answer such petition; if such answer shall admit the jurisdiction of the court, that the claims of the petitioning creditors constitute the amounts necessary to entitle them to file such petition under this section, and that the railroad corporation is either insolvent or unable to meet its debts as they mature, the court shall, upon the filing of the recommendations of the commission in writing, enter an order approving the petition as properly filed under this section if satisfied that it complies with this section and has been filed in good faith, or disapprove it if not so satisfied; and if so approved the proceedings thereon shall continue with like effect as if the railroad corporation had itself filed a petition under this section; if such answer shall deny either the jurisdiction of the court or that the claims of the petitioning creditors constitute

such necessary amounts or that the railroad corporation is insolvent or unable to meet its debts as they mature, the court shall summarily try the issues, and if after the filing of the recommendations of the commission in writing it shall find that the petition complies with this section, and has been filed in good faith, the court shall enter an order approving the petition as properly filed under this section, and the proceedings thereon shall continue with like effect as if the railroad corporation had itself filed a petition under this section; otherwise the court shall dismiss the petition.

"(b) A plan of reorganization within the meaning of this section (1) shall include a proposal to modify or alter the rights of creditors generally, or of any class of them, secured or unsecured, either through the issuance of new securities of any character or otherwise; (2) may include, in addition, provisions modifying or altering the rights of stockholders generally, or of any class of them; (3) shall provide adequate means for the execution of the plan, which may, so far as may be consistent with the provisions of sections 1 and 5 of the Interstate Commerce Act as amended, include the transfer or conveyance of all or any part of the property of the debtor to another corporation or to other corporations or the consolidation of the properties of the debtor with those of another railroad corporation, or the merger of the debtor with any other railroad corporation and the issuance of securities of either the debtor or any such corporation or corporations, for cash, or in exchange for existing securities, or in satisfaction of claims or rights, or for other appropriate purposes; and (4) may deal with all or any part of the property of the debtor. The term 'securities' shall include evidences of indebtedness, either secured or unsecured, bonds, stocks, certificates of beneficial interest therein, and certificates of beneficial interest in property. The term

'stockholders' shall include the holders of voting trust certificates. The term 'creditors' shall, except as otherwise specifically provided in this section, include, for all purposes of this section and of the reorganization plan, its acceptance and confirmation, all holders of claims, interests, or securities of whatever character against the debtor or its property, including claim for future rent, whether or not such claims, interests, or securities would otherwise constitute provable claims under this Act.

"(c) Upon approving the petition as properly filed the judge (1) may temporarily appoint from a panel of standing trustees qualified for such service to be selected and designated in advance by the commission a trustee or trustees of the debtor's estate, who shall have all the title and, subject to the control of the judge and consistently with the provisions of this section, shall exercise all the powers of a trustee appointed pursuant to section 44 or any other section of this Act, and, subject to the judge's control and the jurisdiction of the commission as provided by the Interstate Commerce Act as amended, shall have the power to operate the business of the railroad corporation; (2) shall fix the amount of the bond of such trustee or trustees and require the debtor, the trustee, or trustees to give such notice as the order may direct to creditors and stockholders and to cause publication thereof to be made at least once a week for two successive weeks of a hearing to be held within thirty days after such appointment, at which hearing or any adjournment thereof the judge may make permanent such appointment, or may terminate it and may in the manner herein provided for the appointment of trustees, appoint a substitute trustee or substitute trustees, and in the same manner may appoint an additional trustee or additional trustees, and shall fix the amount of the bond of the substitute or additional trus-

tee or trustees; the trustee or trustees and their counsel shall receive such compensation as the judge may allow within a maximum approved by the commission; (3) may for cause shown, and with the approval of the commission, in accordance with section 20 (a) of the Interstate Commerce Act as amended, authorize the trustee or trustees to issue certificates for cash, property, or other consideration approved by the judge, for such lawful purposes and upon such terms and conditions and with such security and such priority in payments over existing obligations, secured or unsecured, as might in an equity receivership be lawful; (4) shall require the debtor, at such time or times as the judge may direct and in lieu of the schedules required by section 7 of this Act, to file such schedules and submit such other information as may be necessary to disclose the conduct of the debtor's affairs and the fairness of any proposed plan; (5) shall determine a reasonable time within which the claims and interests of creditors and stockholders may be filed or evidenced and after which no such claim or interest may participate in any plan except on order for cause shown; the manner in which such claims and interests may be filed or evidenced and allowed, and, for the purposes of the plan and its acceptance, the division of creditors and stockholders into classes according to the nature of their respective claims and interests; (6) shall cause reasonable notice of such determination, or of the dismissal of the proceedings, or the allowance of fees or expenses, to be given creditors and stockholders by publication or otherwise; (7) if a plan of reorganization is not proposed or accepted, or, if proposed and accepted, is not confirmed, within such reasonable time as the judge may, upon cause shown and after considering any recommendation which has been filed by the commission, allow, may dismiss the proceeding; (8) may, within such maximum limits as

are fixed by the commission, as elsewhere provided in subdivision (f) of this section, allow a reasonable compensation for the services rendered and reimbursement for the actual and necessary expenses incurred in connection with the proceeding and plan by officers, parties in interest, reorganization managers, and committees or other representatives of creditors or stockholders, and the attorneys or agents of any of the foregoing, and by such assistants as the commission with the approval of the judge may specially employ; and (9) may on his own motion or at the request of the commission refer any matters for consideration and report, either generally or upon specified issues, to one of several special masters who shall have been previously designated to act as special masters in any proceedings under this section by order of any Circuit Court of Appeals and may allow such master a reasonable compensation for his services. The Circuit Court of Appeals of each circuit shall designate three or more members of the bar as such special masters whom they deem qualified for such services, and shall from time to time revise such designations by changing the persons designated or reducing or adding to their number, as the public interest may require: *Provided, however,* that there shall always be three of such special masters qualified for appointment in each circuit who shall in their respective circuits hear any matter referred to them under this section by a judge of any District Court. For all purposes of this section claims against a railroad corporation which would have been entitled to priority over existing mortgages if a receiver in equity of the property of the debtor had been appointed by a Federal court at the date of the filing of the petition hereunder shall be entitled to such priority, and holders of such claims shall be treated as a separate class of creditors. If in any case in which the issues have not already been tried under the provisions of subdivision (a) of this section any of the debt-

or's creditors shall, prior to the hearing provided for in subdivision (c), clause (2), of this section, appear and controvert the facts alleged in the petition, the judge shall determine, as soon as may be, the issues presented by the pleadings, without the intervention of a jury, and unless the material allegations of the petition are sustained by the proofs shall dismiss the petition. Any creditor or stockholder shall be heard on the question of the permanent appointment of any trustee or trustees, the proposed recommendation, approval, or confirmation of any reorganization plan, and upon filing a petition for leave to intervene on such other questions arising in the proceeding as the judge shall determine. The debtor, or the trustees if appointed, shall within fifteen days or, upon cause shown, such other time as may be directed by the judge, prepare (1) a list of all known bondholders and creditors of, or claimants against, the debtor or its property, and the amounts and character of their debts, claims, and securities, and the last known post-office address or place of business of each creditor or claimant, and (2) a list of the stockholders of the debtor, with the last known post-office address or place of business of each. The contents of such lists shall not constitute admissions by the debtor or the trustees in a proceeding under this section or otherwise. Such lists shall be open to the inspection of any creditor or stockholder of, or claimant against, the debtor, during reasonable business hours, upon application to the debtor or trustees, as the case may be.

"(d) Before creditors and stockholders of the debtor are asked finally to accept any plan of reorganization, the Interstate Commerce Commission shall after due notice hold a public hearing at which the debtor shall present its plan of reorganization and at which, also, such a plan may be presented by the trustee or trustees, or by or on behalf of creditors of the debtor, being not less

than 10 per centum in amount of any class of creditors. Following such hearing, the commission shall render a report in which it shall recommend a plan of reorganization (which may be different from any which has been proposed) that will, in its opinion be equitable, will not discriminate unfairly in favor of any class of creditors or stockholders, will be financially advisable, will meet with the requirements of subdivision (g) of this section, and will be compatible with the public interest. In such report the commission shall state fully the reasons for its conclusions, and it may thereafter, upon petition for good cause shown, and upon further hearing if the commission shall deem necessary, modify any of its recommendations and conclusions in a supplemental report stating the reasons for such modification. Thereafter the plan of reorganization recommended by the commission shall be submitted in such manner as the commission may direct to the creditors and stockholders of the debtor for acceptance or rejection, together with the report or reports of the commission thereon; and the commission may at the same time afford an opportunity to accept or reject any other plan of reorganization filed as in this subdivision (d) provided.

"(e) A plan of reorganization shall not be finally approved by the commission until it has been accepted in writing and such acceptance has been filed in the proceeding by or on behalf of creditors holding two-thirds in amount of the claims of each class whose claims or interests would be affected by the plan, and by or on behalf of stockholders of the debtor holding two-thirds of the stock of each class: *Provided, however,* that if adequate provision is made in the plan for the protection of the interests, claims, and liens of any class of creditors or stockholders in the manner provided in clauses (5) and (6) of subdivision (g), of this section, then the acceptance of the plan by such class of creditors or

stockholders shall not be requisite to the approval of the plan: *And provided further,* that the acceptance of stockholders shall not be requisite to the confirmation of the plan if (1) the judge shall have determined (a) that the corporation is insolvent, or (b) that the interests of stockholders will not be adversely affected by the plan, or (c) that the debtor has pursuant to authorized corporate action accepted the plan, and its stockholders are bound by such acceptance. For the purposes of this section acceptance by a creditor or stockholder shall include acceptance in writing executed by him; or acceptance by his duly authorized attorney or committee acting under authority executed by him subsequent to the recommendation of the plan by the commission. Upon acceptance of the plan in accordance with the provisions of this subdivision (e) the commission may, without further proceedings, grant authority for the issue of any securities, assumption of obligations, transfer of any property, or consolidation or merger of properties, to the extent contemplated by the plan consistent with the purposes of the Interstate Commerce Act as amended. If the United States of America is directly a creditor or stockholder, the Secretary of the Treasury is hereby authorized to accept or reject a plan in respect of the interests or claims of the United States.

"(f) If the plan recommended by the commission is accepted as provided in subdivision (e), the commission shall thereupon certify the plan to the court together with its approval thereof and that the same has been so accepted, together with a report of the proceedings before it and its conclusions thereon. If the plan accepted as provided in subdivision (e) differs from the plan recommended by the commission it shall, upon acceptance, be submitted to the commission, which shall hear all interested parties upon such notice and subject to such rules and regulations as it shall prescribe. If after such

hearing the commission determines that the accepted plan in its opinion is equitable and will not discriminate unfairly in favor of any class of creditors or stockholders; will be financially advisable; will meet the requirements of subdivision (g) of this section; and will be compatible with the public interest; the commission shall thereupon certify the plan to the court, together with its approval thereof and that the same has been duly accepted, and together with a report of the proceedings before it and its findings and conclusions thereon. The commission shall also, after hearing if necessary, fix the maximum compensation and reimbursement which may be allowed by the court pursuant to clause (8) of subdivision (c) of this section: *Provided,* that unless good and sufficient reasons appear therefor no allowance for fees or compensation shall be made to officers of corporations who have acted as managers or in any capacity in connection with the reorganization when such corporation had an interest in the matter. No plan of reorganization shall be confirmed in any proceeding under this section except upon the approval of the Interstate Commerce Commission certified to the court. If the commission shall decline to issue such a certificate it shall file in the proceeding its decision, specifying the particular grounds upon which it bases its disapproval of the plan.

"(g) Upon such approval by the commission, and after hearing such objections as may be made to the approved plan, the judge shall confirm the plan if satisfied that (1) the approved plan complies with the provisions of subdivision (b) of this section, is equitable and does not discriminate unfairly in favor of any class of creditors or stockholders; (2) all amounts to be paid by the debtor or by any corporation or corporations acquiring the debtor's assets, for services or expenses incident to the reorganization and cost of financing, have

been fully disclosed and are reasonable, or are to be subject to the approval of the judge; (3) the offer of the plan and its acceptance are in good faith and have not been made or procured by any means or promises forbidden by this Act; (4) the approved plan provides for the payment of all costs of administration and other allowances made by the court, except that compensation or reimbursement provided for in subdivision (c), clause (8), of this section may be paid in securities provided for in the plan if those entitled thereto will accept such payment and the court finds such compensation reasonable; (5) the approved plan provides, with respect to stockholders of any class the acceptance of which is requisite to the confirmation of the plan, and who would not become bound by the plan under the provision of subdivision (h) of this section, and of which more than one-third have not accepted the plan, adequate protection for the realization by them of the value of their equity, if any, in the property of the debtor dealt with by the plan either by a sale of the property at not less than a fair upset price, or by appraisal and payment in cash either of the value of their stock or, at the objecting stockholder's election, of the value of the securities, if any, alloted to such stock under the plan; (6) the plan provides with respect to any class of creditors the acceptance of which is requisite to the confirmation of the plan, and who would not become bound by the plan under the provisions of subdivision (h) of this section, adequate protection for the realization by them of the value of their securities, liens, and claims, either (a) by the sale of such property subject to their liens, if any, or (b) by the sale free of such liens at not less than a fair upset price, and the transfer of such liens to the proceeds of such sale, or (c) by appraisal and payment in cash of either the value of such liens and claims or, at the objecting creditors' election, the value of the se-

curities allotted to such liens and claims under the plan. Section 57, clause (h), of this Act shall be applicable to the appraisal of securities under this section, and the value of the unpaid balance shall be appraised as an unsecured claim; and (7) the debtor, and every other corporation issuing securities or acquiring property under the plan, is authorized by its charter or by applicable State or Federal laws, upon confirmation of the plan, to carry out the plan. In the case of a sale or appraisal under clause (5) or (6) of this subdivision (g) the court shall refer to the commission for its consideration and determination the amount to be fixed as the upset price and the appraisal of any securities.

"(h) Upon such confirmation the provisions of the plan shall be binding upon (1) the corporation, (2) all stockholders if the judge shall have determined (a) that the corporation is insolvent, or (b) that the interests of stockholders will not be adversely affected by the plan, or (c) that the debtor has pursuant to authorized corporate action accepted the plan and its stockholders are bound by such acceptance, (3) all stockholders of each class of which two-thirds in amount shall have accepted the plan, (4) all creditors whose claims are payable in cash in full under the plan, (5) all creditors entitled to priority under subdivision (c) of this section, whose claims are not payable in cash in full under the plan, provided two-thirds in amount of such creditors shall have accepted the plan in writing filed in the proceeding, (6) all other unsecured creditors, provided two-thirds in amount of such creditors shall have accepted the plan in writing filed in the proceeding, and (7) all secured creditors of each class of which two-thirds in amount shall have accepted the plan. The confirmation of the plan shall discharge the debtor from its debts except as provided in the plan. Upon confirmation of the plan by the judge, the debtor and other corporations

affected by the plan, or organized or to be organized for the purpose of carrying out the plan, shall, subject to the jurisdiction of the Commission, have full power and authority to put into effect and carry out the plan and the orders of the judge relative thereto, the laws of any State or the decision or order of any State authority to the contrary notwithstanding. In the event that the judge should disapprove the plan he shall file an opinion stating his reasons therefor.

"(i) The provisions of sections 721, 722, 723, 724, and 725 of the Revenue Act of 1932 shall not apply to the issuance, transfers, or exchange of securities or filing of conveyances to make effective any plan of reorganization confirmed under the provisions of this section.

"(j) Upon the confirmation of the plan the property dealt with by the plan, when transferred and conveyed to the debtor or other corporation or corporations provided for by the plan, or if no trustee or trustees have been appointed when held by the debtor pursuant to the plan, shall, as the court may direct, be free and clear of all claims of the debtor, its stockholders and creditors, except such as may consistently with the provisions of the plan be reserved in the order confirming the plan or directing such transfer and conveyance, and the court may direct the trustee or trustees, or if there be no trustee or trustees the debtor, to make any such transfer and conveyance, and may direct the debtor to join in any such transfer or conveyance made by the trustee or trustees. Upon the termination of the proceeding a final decree shall be entered discharging the trustee or trustees, if any, making such provisions as may be equitable, and closing the case.

"(k) If a receiver of all or any part of the property of a corporation has been appointed by a Federal or State court, whether before or after this amendatory

Act takes effect, the railroad corporation may nevertheless file a petition or answer under this section at any time thereafter, but if it does so and the petition is approved the trustee or trustees appointed under the provisions of this section shall be entitled forthwith to possession of such property, and the judge shall make such orders as he may deem equitable for the protection of obligations incurred by the receiver and for the payment of such reasonable administrative expenses and allowances in the prior proceeding as may be fixed by the court appointing said receiver within maximum limits approved by the commission. If a receiver has been appointed by a Federal or State court prior to the dismissal under subdivision (c), clause (7), of a proceeding under this section, the judge may include in the order of dismissal appropriate provisions directing the trustee to transfer possession of the debtor's property within the territorial jurisdiction of such court to the receiver so appointed, upon such terms as the judge may deem equitable for the protection of obligations incurred by the trustee and for the payment of administrative expenses and allowances in the proceeding hereunder. For the purposes of this section the words 'Federal court' shall include the district courts of the United States and of the Territories and possessions to which this Act is or may hereafter be applicable, the Supreme Court of the District of Columbia, and the United States Court of Alaska.

"(l) In addition to the provisions of section 11 of this Act for the staying of pending suits against the debtor, such suits shall be further stayed until after final decree the judge may, upon notice and for cause shown, enjoin or stay the commencement or continuance of any judicial proceeding to enforce any lien upon the estate until after final decree.

"(m) A certified copy of an order confirming a plan of reorganization shall be evidence of the jurisdiction of the court, the regularity of the proceedings, and the fact that the order was made. A certified copy of an order directing the transfer and conveyance of the property dealt with by the plan as provided in subdivision (j) of this section shall be evidence of the transfer and conveyance of title accordingly, and if recorded shall impart the same notice that a deed if recorded would impart.

"(n) In proceedings under this section and consistent with the provisions thereof, the jurisdiction and powers of the court, the duties of the debtor and the rights and liabilities of creditors, and of all persons with respect to the debtor and his property, shall be the same as if a voluntary petition for adjudication had been filed and a decree of adjudication had been entered on the day when the debtor's petition was filed.

"(o) No judge or trustee acting under this Act shall change the wages or working conditions of railroad employees; except in the manner prescribed in the Railroad Labor Act, or as set forth in the memorandum of agreement entered into in Chicago, Illinois, on January 31, 1932, between the executives of twenty-one standard labor organizations and the committee of nine authorized to represent Class 1 railroads.

"(p) No judge or trustee acting under this Act shall deny or in any way question the right of employees on the property under his jurisdiction to join the labor organization of their choice, and it shall be unlawful for any judge, trustee or receiver to interfere in any way with the organizations of employees, or to use the funds of the railroad under his jurisdiction, in maintaining so-called company unions, or to influence or coerce employees in an effort to induce them to join or remain members of such company unions.

"(q) No judge, trustee, or receiver acting under this Act shall require any person seeking employment on the property under his jurisdiction to sign any contract or agreement promising to join or to refuse to join a labor organization; and if such contract has been enforced on the property prior to the property coming under the jurisdiction of said judge, trustee, or receiver, then the said judge, trustee, or receiver, as soon as the matter is called to his attention, shall notify the employees by an appropriate order that said contract has been discarded and is no longer binding on them in any way.

"(r) The term 'railroad corporation' as used in this Act means any common carrier by railroad engaged in the transportation of persons or property in interstate commerce, except a street, suburban, or interurban electric railway which is not operated as a part of a general railroad system of transportation or which does not derive more than 50 per centum of its operating revenues from the transportation of freight in standard steam railroad freight equipment.

"(s) In proceedings under this section, claims for personal injuries to employees of a railroad corporation, and claims of personal representatives of deceased employees of a railroad corporation arising under State or Federal laws, shall be preferred claims against the assets of such railroad corporation in receivership or in reorganization as herein provided, such claims to be subordinate only to costs of administration of such receivership or reorganization."

SEC. 2. This Act shall take effect and be in force from and after the date of its approval, and shall apply as fully to debtors, their stockholders and creditors, whose interest or debts, whether secured or unsecured, have been acquired or incurred prior to such date, as to debtors, their stockholders and creditors, whose interest or

debts have been acquired or incurred after such date. Proceedings under section 1 of this Act may be taken in proceedings in bankruptcy which are pending on the effective date of this Act.

SEC. 3. In all bankruptcy proceedings the officers and agents in charge of the bankrupt funds are authorized to deposit the same without limit as to amount in the postal savings depositories at the prescribed interest rate in all cases where local banks are unable or unwilling to give the required security. Such deposit or any portion thereof may be withdrawn as required in the bankruptcy proceedings.

Approved, March 3, 1933.

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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1935

No. 743

FRANK O. LOWDEN, JAMES E. GORMAN and JOSEPH B. FLEMING, as Trustees of the Estate of THE CHICAGO, ROCK ISLAND AND PACIFIC RAILWAY COMPANY,

Appellants Below,

vs.

NORTHWESTERN NATIONAL BANK AND TRUST COMPANY OF MINNEAPOLIS, MINNESOTA, formerly THE NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS, MINNESOTA,

Appellee Below.

ON CERTIFICATE FROM THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

REPLY BRIEF AND ARGUMENT FOR APPELLANTS BELOW

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ON CERTIFICATE FROM THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

REPLY BRIEF AND ARGUMENT FOR APPELLANTS BELOW

I.

Appellee's argument that to construe Section 77 so as to preclude the right of set-off under Section 68 would violate the Fifth Amendment. (Page 31.)

The basic argument seems to be this: that to deny the right of set-off in this action will forever preclude

the bank from the benefit of certain equities which it asserts it has. We deny that it has any such equities, but it seems clear that if they do exist, they must be determined and made effective by the plan, and in no other way.

Counsel seek to distinguish the *Continental Bank* case on the theory that it merely precluded creditors from then exercising their remedies, but did not affect their substantive rights, while to deny the right of set-off here would be, not merely to stay the remedy, but to take away a vested right as well. It should, however, be borne in mind that what the bank here asks is, not only that its so-called "vested right" be protected, but that upon the filing of a petition under Section 77, *it be permitted to exercise that right.* In effect, it asks, and the Court below permitted, just what this Court denounced in the *Continental Bank* case, *an immediate foreclosure pending reorganization.*

When this is borne in mind, it is apparent that the bank must do what all other lienholders and claimants must do, await the presentation and confirmation of the plan, and be accorded such rights only as the plan gives it. In other words, the bank's only remedy is to insist that it and all other banks in a like situation be put in a separate class by the Interstate Commerce Commission and the Bankruptcy Court, and that their rights in the property of the debtor, of which the funds in this bank account are a part, be dealt with equitably under the plan. The bank is deprived of no right because, whatever be its rights, it can assert them before the Bankruptcy Court.

To say that because subdivision (j) refers to "property dealt with by the plan" and that if the right of set-off is recognized, the funds from this bank account will not be "dealt with by the plan" (Appellee's Brief, page 20) is to reason in a vicious circle. The same argu-

ment with like force could be made to sustain the right of immediate foreclosure upon a first lien on a railroad's main line. As we have repeatedly pointed out, what property is to be dealt with by the plan is to be determined by the Interstate Commerce Commission and the Court, with full right to all creditors and lienholders to be heard, and not by each individual creditor acting for himself. But in the meantime, all properties of the debtor are within the exclusive jurisdiction of the Bankruptcy Court.

But aside from all this, the argument falls of its own weight, because it assumes that at the date of the passage of the act (March 3, 1933), the bank had a vested right of set-off. The reverse is true. At the moment Section 77 became effective, the bonds were not due, and the railway was neither insolvent nor unable to meet its debts as they matured.[1] There was no reorganization petition filed, contemplated, or (until after the act was passed) possible. Therefore, when the act became effective there existed no right of set-off either in law or in equity under any theory. Of course, in addition to all this, Section 68 at that time had no application, because the Bankruptcy Act did not apply to railroads. If Section 77 and the proceedings under it be eliminated, no possible right of set-off then existed on any theory.

On pages 29 and 30, counsel refer to subdivision (g), quoting part of the language to the effect that the plan shall provide

> "adequate protection for the realization by them of the value of their securities, liens and claims."

It is true that this subdivision contains such language, but counsel's reference to it is misleading in that there

[1] Even after the passage of Section 77, the railway continued to pay its debts as they became due. On June 7, 1933, there was no default "in the payment of either principal or interest" of its bonds (R. 2). The April 1, 1933, interest must have been met, as well as the interest due October 1, 1932. The findings of the trial Court show this definitely (11 Fed. Supp. 929 (931-Column 2)).

is a failure to quote the language immediately preceding, which expressly states that it applies only to creditors "who would not become bound by the plan."

As originally pointed out, if the bank has any such equities, which require recognition, they will be protected by the plan.

II.

Appellee's argument that "insolvency," within the rule that the debtor must be insolvent in order to accelerate its debts, means mere inability to meet debts as they mature. (Page 42.)

It perhaps may not be necessary to determine what the meaning of the word "insolvency" within this rule is generally, since it seems entirely clear that the Congress by the passage of Section 77 never intended that a solvent railway's bonded indebtedness should become immediately due upon the filing of a petition. If it did not intend to preclude all set-offs, it certainly did not intend to place a solvent railway in a worse position than it was before, and to provide that upon a solvent railway's taking advantage of Section 77, all debts became immediately capable of enforcement, which otherwise would not have been enforceable for many years to come.

Counsel brushes aside any argument based on the intention and purpose of Congress with the statement that such purpose is unimportant. The proposition is stated thus (page 24):

> "Parties to a contract, or legislative bodies, may have a purpose, even clearly beyond dispute, but they may omit to make actual provisions necessary to give effect thereto."

This overlooks the familiar rule that the intent and purpose of the legislative body is the important factor in the construction of a statute. This Court expressed the idea in the *Continental Bank* case, saying:

> "And to prevent the attainment of that object is to defeat the very end, the accomplishment of which was the sole aim of the section, and thereby to render its provisions futile."

In fact, a Court may and should construe an act in the face of the strict letter of the law when necessary to accomplish what Congress intended.

Church of Holy Trinity v. *United States,* 143 U. S. 457.

Fleischmann Construction Company v. *United States,* 270 U. S. 349.

However, it is clear that the word "insolvency," as used in the rule that insolvency accelerates debts, means actual excess of liabilities over assets.

"Insolvency" has, of course, a variety of meanings, depending upon the phase of the law under consideration. It may have different meanings in different statutes, and a different meaning from either in common parlance, all depending on the circumstances.[2]

Not one of the cases cited by the bank has the slightest application to the question here.

Steele v. *Randall,* 19 Fed. (2d) 40 (8th Circuit), and *Federal Reserve Bank* v. *Idaho Grimm Alfalfa Seed Growers' Association,* 8 Fed. (2d) 922 (9th Circuit), had to do with the question of insolvency of national banks under the National Banking Act, 11 U. S. C. 91. There is no doubt that the word "insolvent," *as used in the Banking Act,* means inability to meet its debts as they

[2] See 30 Michigan Law Review, 1040, "When is a corporation insolvent?" and 14(a) C. J. Section 3058.

mature. (*Federal Intermediate Credit Bank* v. *L'Herisson,* 33 Fed. (2d) 841 (8th Circuit); *Aycock* v. *Bradbury,* 77 Fed. (2d) 14 (10th Circuit). Compare *United States* v. *Oklahoma,* 261 U. S. 253.)

In neither case was there a distinction made between actual insolvency and inability to meet current debts. In the *Steele* case actual insolvency seems to have been conceded, the only question being the time when this occurred, and the *Idaho Association* case was disposed of by a determination by the Court that the evidence supported a finding that the bank was "insolvent, if indeed it was not wholly and hopelessly so."

It, of course, ought to be the law, as it is, that a national bank is insolvent "when it cannot pay its depositors on demand in accordance with its promise."

In recognition of this, there has always been a distinction between what constitutes insolvency on the part of a banker, trader, or merchant and those engaged in other lines. As to the former, insolvency usually means mere inability to meet its debts as they mature. As to the latter, it means excess of liabilities over assets.

Toof v. *Martin,* 13 Wall. 40.
Wager v. *Hall,* 16 Wall. 584 (599).
Steele v. *Allen,* 240 Mass. 394; 134 N. E. 401.
Williamson v. *Hatch,* 55 Minn. 344; 57 N. W. 56.
Daniels v. *Palmer,* 35 Minn. 347; 29 N. W. 162.
Crenshaw v. *Halvorsen,* 183 Ia. 148; 165 N. W. 360.

The latter is "its general and popular meaning." *Toof* v. *Martin, supra*; *Ratcliff* v. *Clendenin,* 232 Fed. 61 (8th Circuit); *Crenshaw* v. *Halvorsen, supra*; *Frank* v. *Stearns,* 111 Neb. 101; 195 N. W. 949.

The other cases cited by appellee merely enunciate the familiar rule that inability to meet debts as they

mature may be, in connection with other matters, ground for the appointment of a receiver in equity. So far as we know, this has never been questioned. Most equity receiverships exist because the debtor is not insolvent but only financially embarrassed.

On page 46, counsel argue that the bonds should be regarded as having matured, because in its petition the railway announced its inability "to meet its debts as they mature." In other words, it is sought to invoke the rule of "anticipatory breach of contract." It is a sufficient answer to this suggestion to call attention to the fact that whatever may be the extent of the application of this rule to contracts generally, it does not apply to a mere unilateral contract to pay money.

> "In the case of an ordinary money contract, such as a promissory note, or a bond, the consideration has passed; there are no mutual obligations; and cases of that sort do not fall within the reason of the rule."
>
> *Roehm* v. *Horst,* 178 U. S. 1 (17).

III.

Appellee's argument that because the bonds matured by their terms before the trial, the right of set-off should be recognized. (Page 47.)

The argument that it is the duty of the Court to deal with the situation as it existed at the time of trial, even if it is sound, does not help the bank in the least. If it be conceded that because the bonds were not then due no right of set-off existed on June 7, 1933, then from that time the bank was wrongfully withholding funds, no longer belonging to the railway, but belonging to these trustees. If, then, the bank is permitted on and after April 1, 1934, when the bonds came due, to set them off against the funds so withheld by it, it would

amount to the Court's countenancing a set-off of obligations of the railway against funds of the trustees under the control of the Court. Merely to state the argument is to refute it. The obstacle to the application of the rule for which the bank contends lies in the fact that after June 7, 1933, and at the time of trial, the bank owed the railway nothing, but its indebtedness was to the trustees. It is the time of filing the petition which determines the right of set-off.

McDaniel National Bank v. *Bridwell,* 74 Fed. (2d) 331 (8th Circuit).

Corn Exchange National Bank v. *Locher,* 151 Fed. 764 (3rd Circuit).

However, it would hardly seem that this question arises upon any of the questions certified.

IV.

Appellee's argument that under the old Bankruptcy Law a person may go through voluntary bankruptcy even though solvent. (Page 38.)

Section 3 of the Bankruptcy Act (11 U. S. C. 21), defining acts of bankruptcy, reads as follows:

> "(a) Acts of bankruptcy by a person shall consist of his having (1) conveyed, transferred, concealed, or removed, or permitted to be concealed or removed, any part of his property with intent to hinder, delay, or defraud his creditors, or any of them; or (2) transferred, while insolvent, any portion of his property to one or more of his creditors with intent to prefer such creditors over his other creditors; or (3) suffered or permitted, while insolvent, any creditor to obtain a preference through legal proceedings, and not having at least five days before a sale or final disposition of any property affected by such preference vacated or dis-

> charged such preference; or (4) made a general assignment for the benefit of his creditors, or, being insolvent, applied for a receiver or trustee for his property or because of insolvency a receiver or trustee has been put in charge of his property under the laws of a State, of a Territory, or of the United States; or (5) admitted in writing his inability to pay his debts and his willingness to be adjudged a bankrupt on that ground."

It is, therefore, clear that except in cases falling within Section 3 (a), (4), relating to assignments for the benefit of creditors (*West Company* v. *Lea*, 174 U. S. 590), the act was clearly intended to apply only to those creditors who were actually insolvent. Even in such a case, there must in reality be insolvency on the part of the debtor, because by the assignment he has divested himself of all his property, although before he made the assignment he may not have been actually insolvent. While it is, of course, true that neither Section 3 (a), (1), nor Section 3 (a), (5), uses the word "insolvent," they describe a situation within the definition of insolvency contained in Section 1, (15), of the Bankruptcy Act. (See page 23, Appellants' original brief.) As already indicated, Section 3 (a), (5), provides that an act of bankruptcy consists in having "admitted in writing his *inability to pay his debts* and his willingness to be adjudged a bankrupt on that ground."

Form No. 1 (debtor's petition), prescribed by the general bankruptcy orders of this Court (172 U. S. 653), requires that a voluntary bankrupt must allege "that he owes debts *which he is unable to pay in full.*" (172 U. S. 667.)

The meaning of the words "*inability to pay* his debts" and "debts which he is *unable to pay in full*" is clear. Contrast them with the words used in Section 77 "unable to meet its debts as they mature." The former

means insolvency. This Court specifically so held in *Cunningham* v. *Norton,* 125 U. S. 77, where it said with respect to substantially the same words used in an assignment for the benefit of creditors:

> "When a person is unable to pay his debts, he is understood to be insolvent. It is difficult to give a more accurate definition of insolvency."

The latter means "one who although unable to pay promptly may be able to pay if time to do so be sufficiently extended." (*Continental Bank* case.)

It is inconceivable that there could be an adjudication in bankruptcy under a voluntary petition which alleged that the debtor was perfectly solvent and perfectly able to pay his debts.

Therefore, the reason (*i.e.,* insolvency) for allowing the set-off of an unmatured claim in a bankruptcy proper is entirely absent here, because there is no insolvency.

V.

Appellee's discussion of Question 3 (Page 50.)

Most of appellee's discussion of Question 3 is devoted to "the extent of, and limitations upon the jurisdiction of the bankruptcy court under the general provisions of the Bankruptcy Act." This is interesting, but academic here. In any event the conclusions drawn by appellee are not in accord with the decisions of this Court. A very good statement of the law, as it is established by recent decisions of this Court, is found in *Taylor* v. *Sternberg* (1935), 293 U. S. 470, 79 L. ed. 599, where the Court said:

> "Upon adjudication in bankruptcy, all the property of the bankrupt vests in the trustee as of the date of the filing of the petition. Upon such filing,

> the jurisdiction of the bankruptcy court becomes paramount and exclusive; and *thereafter that court's possession and control of the estate cannot be affected by proceedings in other courts, whether state or federal. Gross* v. *Irving Trust Co.,* 289 U. S. 342, 344, 77 L. ed. 1243, 1244, 53 S. Ct. 605, 90 A. L. R. 1215, 22 Am. Bankr. Rep. (N. S.) 661; *Acme Harvester Co.* v. *Beekman Lumber Co.,* 222 U. S. 300, 307, 56 L. ed. 208, 213, 32 S. Ct. 96, 27 Am. Bankr. Rep. 262; *Re Diamond* (C. C. A. 6th) 259 F. 70, 73, 44 Am. Bankr. Rep. 278. This applies while the possession is constructive as well as when it becomes actual. *Mueller* v. *Nugent,* 184 U. S. 1, 14, 46 L. ed. 405, 411, 22 S. Ct. 269, 7 Am. Bankr. Rep. 224; *Taubel-Scott-Kitzmiller Co.* v. *Fox,* 264 U. S. 426, 432, 433, 68 L. ed. 770, 773, 774, 44 S. Ct. 396, 2 Am. Bankr. Rep. (N. S.) 912; *Orinoco Iron Co.* v. *Metzel* (C. C. A. 6th) 230 F. 40, 44, 45; and cases cited." (Italics supplied.)

Nor have we erroneously construed the *Cumberland Glass* case, as contended by appellee. We cited that case to call the attention of the Court to the emphasis placed by the Court upon the words in Section 68(a) "the account shall be stated." The fact that the Court referred in its opinion to cases in the state courts permitting a set-off in plenary actions is not material; because the question here involved does not appear to have been raised in those cases. For instance, *Wasey* v. *Whitcomb,* 167 Mich. 58, 132 N. W. 572, involved essentially only the actual amount due by the defendant to the bankrupt, on a contract to finance the sale of pianos. *Wagner* v. *Burnham,* 224 Pa. 586, 73 Atl. 990, was a suit by the trustee of a bankrupt building contractor to recover the amount due on a building contract. The Court merely held that from the amount due must be deducted the amount required to discharge subcontractors' liens. The question of forum was not involved.

In any event the law, as it stands, even under the old Act, is stated in *Isaacs* v. *Hobbs Tie & Timber Co.*, 282 U. S. 734, where this Court said:

> "Thus, while valid liens existing at the time of the commencement of a bankruptcy proceeding are preserved, *it is solely within the power of a court of bankruptcy to ascertain their validity and amount and to decree the method of their liquidation.*" (Italics supplied.)

When we come to consider the procedure under Section 77, however, the situation is clear beyond dispute; because that section, both as originally passed and as amended in 1935, conferred upon the Bankruptcy Court *exclusive jurisdiction* of the debtor and its property wherever located. Even before the 1935 amendment this Court had held that the process of the Bankruptcy Court in the exercise of the powers conferred by Section 77 might run beyond its immediate territorial jurisdiction (*Ex Parte Baldwin,* 291 U. S. 610). The construction contended for by appellee would eliminate the word "exclusive" from the statute.

Appellee cites the case of *In re Prudence-Bonds Corporation,* (C. C. A. 2nd) 75 F. (2d) 262, as authority for the proposition that Congress did not intend the Bankruptcy Court, in proceedings under Section 77B, to take over all litigation between the debtor and third parties (Appellee's Brief, page 64). That citation disposes of the point made by appellee that the trustees in bankruptcy here should not be heard to deny the jurisdiction of the Minnesota court which they have voluntarily invoked. The trustees are not denying that jurisdiction. They are merely asking the aid of the Minnesota court (as sanctioned in the *Prudence-Bonds* case cited by appellee) to compel the bank to turn over to the trust estate property in its possession. All that they are denying is the right of the bank to assert in the Minnesota

court a claim to set-off. The trustees deny this right because Section 77 makes the Bankruptcy Court the exclusive forum for the determination of that question.

If authority were needed in addition to that already cited, a complete and clear exposition of the matter is found in a subsequent decision of the Circuit Court of Appeals for the Second Circuit in the same *Prudence-Bonds* proceeding. Another phase of that case reached the Circuit Court of Appeals on the question of an injunction to restrain trustees of mortgages made by the bankrupt from disposing of the collateral securing those mortgages, this collateral consisting of large numbers of real estate mortgages. See *In re Prudence-Bonds Corporation,* (C. C. A. 2nd, 1935) 77 F. (2d) 328, certiorari denied by this Court October 14, 1935. Although we do not wish to weary the Court with citations, we quote particularly the following language which illustrates clearly the point we have in mind:

> "Formerly, the court, while having jurisdiction of whatever equity a bankrupt might own in pledged property, did not have jurisdiction over the property itself. The property was in the possession of the pledgee, and the bankrupt having neither real nor constructive possession thereof, the bankruptcy court had no jurisdiction over it. *Taubel, etc., Co.* v. *Fox,* 264 U. S. 426, 44 S. Ct. 396, 68 L. Ed. 770. But the present grant of jurisdiction, under section 77B, contains no limitation which excludes property subject to a lien or mortgage.
>
> * * * * *
>
> "The court of reorganization can bring within its jurisdiction property covered by mortgage or pledge, when a plan covering it has been adopted and confirmed. And prior thereto, property held by a pledgee, in which the debtor has an equity, is likewise within the court's jurisdiction, so as to prevent a disposition by foreclosure of the pledge or mortgage. For the purpose of reorganization,

the court should take complete charge of property in order that it may from the beginning, and through all the intermediate steps of reorganization, so administer the property as to achieve the desired rehabilitation."

Respectfully submitted,

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FILE COPY

Supreme Court of the United States

OCTOBER TERM, 1935.

No. 743.

FRANK O. LOWDEN, JAMES E. GORMAN AND JOSEPH B. FLEMING, AS TRUSTEES OF THE ESTATE OF THE CHICAGO, ROCK ISLAND AND PACIFIC RAILWAY COMPANY,

Appellants Below,

vs.

NORTHWESTERN NATIONAL BANK AND TRUST COMPANY OF MINNEAPOLIS, MINNESOTA, FORMERLY THE NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS, MINNESOTA,

Appellee Below.

ON CERTIFICATE FROM THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

BRIEF AND ARGUMENT FOR APPELLEE BELOW.

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Supreme Court of the United States

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Appellants Below,

vs.

NORTHWESTERN NATIONAL BANK AND TRUST COMPANY OF MINNEAPOLIS, MINNESOTA, FORMERLY THE NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS, MINNESOTA.

Appellee Below.

ON CERTIFICATE FROM THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

BRIEF AND ARGUMENT FOR APPELLEE BELOW.

OPINION BELOW.

The opinion of the District Court below was filed June 17, 1935. It is reported as *Lowden, et al., vs. Northwestern National Bank and Trust Company of Minneapolis,* in 11 Fed. Suppl. 929 (D. C., Minn.). The Circuit Court of Appeals has filed no opinion, reserving decision pending the opinion of this Court upon the questions certified.

JURISDICTION.

The Circuit Court of Appeals has certified three questions of law to this Court for instructions. Jurisdiction of this Court rests upon the certificate so made, pursuant to Section 239 of the Judicial Code, as amended (28 U. S. C. A., §346).

QUESTIONS PRESENTED.

The questions here presented are those certified as follows:

Question 1. Does the right of set-off recognized by Section 68 (a) of the Bankruptcy Act apply to reorganization proceedings under Section 77 of that Act?

Question 2. If the first question be answered in the affirmative, can a bank which owns the unmatured bonds of a railroad corporation set off a deposit account of the railroad with the bank against the bonds, upon the filing by the railroad of a petition for reorganization under Section 77 of the Bankruptcy Act, alleging that the railroad is unable to meet its debts as they mature?

Question 3. If the first and second questions be answered in the affirmative, may the United States District Court for the District of Minnesota, in the suit by the trustees of the railroad's estate to recover the amount deducted from the account of the railroad by the bank under the claimed right of set-off, recognize and establish as a proper set-off by the bank one which was not made until after the filing of the petition for reorganization and which has never been ordered, authorized, approved, or consented to by the court in which that petition was filed and approved?

STATUTES INVOLVED.

The statutes directly involved are §77 of the Bankruptcy Act (as adopted March 3, 1933), 11 U. S. C. A., §205; and §68 of the Bankruptcy Act., 11 U. S. C. A., §108.

Section 77 is set forth in full as an appendix to appellants' brief. Accordingly, it is here omitted.

Section 68 reads as follows:

> "(a) In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid.
>
> (b) A set-off or counterclaim shall not be allowed in favor of any debtor of the bankrupt which (1) is not provable against the estate; or (2) was purchased by or transferred to him after the filing of the petition, or within four months before such filing, with a view to such use and with knowledge or notice that such bankrupt was insolvent, or had committed an act of bankruptcy."

STATEMENT OF CASE.

A statement of the case is here omitted. It is found at pages 1-3 of the certificate and at pages 2-4 of appellants' brief.

SUMMARY OF ARGUMENT.

I.

Certain underlying principles. In the consideration of the three certified questions, certain aspects of the set-off right should be kept in mind:

A. It is not a mere matter of procedural remedy but a substantive right in the nature of a possessory lien,

favorably regarded and liberally treated by the courts.

B. The right comes into existence when the relationship of mutual debtors arises, though its exercise or enforcement may be dependent upon the subsequent occurrence of certain conditions.

II.

Question 1. Does the right of set-off recognized by Section 68 (a) of the Bankruptcy Act apply to reorganization proceedings under Section 77 of that Act?

This question should be answered in the affirmative:

A. Under provisions of the Bankruptcy Act antedating §77, the title of the debtor passing to the trustee has long been subject to valid liens, including the set-off right.

B. A proper construction of §77 requires the conclusion that the substantive set-off right was not thereby abrogated:

1. The exercise of the set-off right under §68 (a) is "consistent with the provisions" of §77 and hence affirmatively preserved by subdivision (n) of §77 (App. Br., p. 54).

2. The contended contrary construction rests upon implication alone, which is an inadequate basis to establish an intended repeal of §68 (a) or an intended abrogation of the long-established policy of recognition of the equitable set-off right, and of all substantive lien rights in bankruptcy proceedings.

3. Subd. (g), subd. par. 6 (App. Br., p. 50), re-

quiring adequate protection of creditors' "securities, liens and claims" and subdivisions (d) and (g) (sub. par. 1), prohibiting discrimination against any creditors, necessarily contemplate preservation of the substantive set-off "lien" in common with all other liens.

4. Such a contrary construction would present reasonable and serious doubts as to constitutionality.

C. If §77 be construed as intending or providing abrogation of the set-off right, it is, to that extent, unconstitutional, as violating the Fifth Amendment.

III.

Question 2. If the first question be answered in the affirmative, can a bank which owns the unmatured bonds of a railroad corporation set off a deposit account of the railroad with the bank against the bonds, upon the filing by the railroad of a petition for reorganization under Section 77 of the Bankruptcy Act, alleging that the railroad is unable to meet its debts as they mature?

This question should be answered in the affirmative because:

A. Neither insolvency nor maturity of the debt is essential to the exercise of the set-off right under §68.

1. Insolvency is not an essential because

(a) It is not a prerequisite to bankruptcy proceedings even under the general provisions of the Act.

(b) Section 68 provides for set-off in *all* cases

arising under the Act, except as limited by subdivision (b).

2. A debt not matured is nevertheless provable and hence may be set off.

B. If the right depended in the alternative upon maturity of the debt or non-maturity plus insolvency, the right exists under the facts stated or permissively to be assumed under Question 2.

1. Any possible requisite of maturity is eliminated because the question assumes insolvency within the equity concept.

2. Any possible requisite of insolvency is eliminated because the facts stated or which may be assumed under Question 2 require that the bonds be regarded as matured:

(a) As initiation of general proceedings "matures" a debt, so the filing of a petition under §77 declaring inability to pay the very bonds in question requires that they be treated as matured.

(b) Their actual maturity and default prior to the trustees' suit and its trial required the court below to determine the equities as then existing.

IV.

Question 3. If the first and second questions be answered in the affirmative, may the United States District Court, for the District of Minnesota, in the suit by the trustees of the railroad's estate to recover the amount deducted from the account of the railroad by

the bank under the claimed right of set-off, recognize and establish as a proper set-off by the bank one which was not made until after the filing of the petition for reorganization and which has never been ordered, authorized, approved, or consented to by the court in which that petition was filed and approved.

A. This question should be answered in the affirmative:

1. In proceedings under the general provisions of the Bankruptcy Act, such set-off right is recognized and enforced in such a plenary action by the trustees outside the territorial limits of the bankruptcy court, under the following principles determining its jurisdiction:

   (a) The jurisdiction of the bankruptcy court is an administrative jurisdiction exercisable by summary proceedings and extending and confined to the debtor and his property within the actual or constructive possession of the court.

   (b) In exercising that jurisdiction, the bankruptcy court cannot issue process either *in rem* or *in personam* beyond its territorial limits, but must resort to ancillary administration.

   (c) The bankruptcy court has no jurisdiction over controversies between the trustee and third parties as to debts owed or property adversely possessed and claimed by third parties (with exceptions here immaterial); such controversies must be determined in plenary actions by the trustee in other courts.

(d) Accordingly, it has long been established that such set-off is to be recognized in a plenary action by a trustee in another court; and this even though the claim so set off has not been proved in the bankruptcy court.

2. Whatever enlarged jurisdiction is deemed conferred by §77, the provisions of that amendment should not be construed as preventing recognition of set-off in a plenary action properly instituted by the trustees in another court:

(a) Cogent reasons sustain a construction of §77 as extending administrative jurisdiction exercisable by summary proceedings beyond the territorial limits of the court, thereby dispensing with the necessity for ancillary administration.

(b) Cogent reasons preclude construction of §77 as creating plenary jurisdiction to adjudicate controversies concerning debts owed the estate, or property adversely possessed and claimed, by third parties beyond the territorial jurisdiction; therefore, the Minnesota Court had jurisdiction to entertain the trustees' suit and determine the set-off right therein.

(c) Even if §77 were to be construed as vesting such plenary jurisdiction in the bankruptcy court, the latter court may consent to the exercise of such jurisdiction by other competent courts; and here, such consent should be assumed from the fact

of the trustees' invoking of the jurisdiction of the Minnesota District Court.

B. A negative answer could only rest upon a view that §77 vests unlimited plenary jurisdiction *exclusively* in the bankruptcy court, rendering any proceedings in the Minnesota court a nullity and requiring dismissal of the trustees' suit below. Such an answer, if reached, should be so explained or qualified as to avoid an improper result of sustaining the trustees' suit while denying the set-off.

ARGUMENT.

I.

Certain Underlying Principles.

There are certain characteristics of the set-off right which have an important bearing upon some of the contentions hereinafter discussed. Wholly aside from them, we believe the three questions each require an affirmative answer. However, certain fundamental concepts as to the nature of the right furnish additional reasons making that conclusion imperative.

A. The Right Is in the Nature of a Substantive Lien to Be Favorably Regarded and Treated.

The set-off right is not a mere matter of procedural remedy but *a substantive right in the nature of a possessory lien.* It is a right long established, recognized and favored by courts of equity. Section 68 (a) of the Bankruptcy Act did not create the right but provided for its recognition and enforcement in bankruptcy proceedings.

In *Studley vs. Boylston National Bank*, 229 U. S. 523, this court, in sustaining the right in bankruptcy proceedings, said:

"That section did not create the right of set-off, but recognized its existence, and provided a method by which it could be enforced even after bankruptcy. What the old books called a right of stoppage—what business men call set-off—is a right given or recognized by the commercial law of each of the states, and is protected by the bankruptcy act if the petition is filed before the parties have themselves given checks, charged notes, made book entries, or stated an account whereby the smaller obligation is applied on the larger.

The banker's lien on deposits, the right of retention and set-off of mutual debts, are frequently spoken of as though they were synonymous, while in strictness, a set-off is a counterclaim which the defendant may interpose by way of cross-action against the plaintiff. But, broadly speaking, it represents the right which one party has against another to use his claim in full or partial satisfaction of what he owes to the other. That right is constantly exercised by business men in making book entries whereby one mutual debt is applied against another."

In *Carr vs. Hamilton*, 129 U. S. 252, the court said:

"Natural justice and equity would seem to dictate that the demands of parties mutually indebted should be set off against each other, and that the balance only should be considered as due. But the common law, for simplicity of procedure, determined otherwise, and held that each claim must be prosecuted separately. 'The natural sense of mankind,' says Lord Mansfield, 'was first shocked at this in the case of bankrupts; and it

was provided for by 4 Anne, c. 17, §11, and 5 Geo. II, c. 30, §28.' *Green vs. Farmer,* 4 Burr, 2220, cited in 2 *Story, Eq. Jur.,* §1433. In pursuance of these old statutes, and of the dictates of equity, the principle of set-off between mutual debts and credits has for nearly two centuries past been adopted in the English Bankrupt Laws, and has always prevailed in our own whenever we have had such a law in force on our statute book; and it mattered not whether the debt was due at the time of bankruptcy or not."

In *The Gloria, etc.,* 286 Fed. 188, upon the express theory that the right of set-off is not "regarded as a mere matter of procedure" but as "affecting the substantive rights of the litigants," the court held that it should be established and enforced against the claims of sovereign states, stating that

> "Once the state has chosen its forum, there seems little reason in law or policy why it should not be subject to the substantive requirements of law and justice."

Upon certification by the Circuit Court of Appeals for the Second Circuit, as to whether the District Court had power to enter such a decree, this court, under the title *Luckenbach S. S. Co. vs. Norwegian Barque,* 266 U. S. 328, answered in the affirmative, stating that

> "the reasons are strong for not obstructing the application of natural justice against the government by technical formulas when justice can be done without endangering any public interest."

In *Central Appalachian Co. vs. Buchanan,* 90 Fed. 454 (6 C. C. A., before Taft and Lurton, Circuit Judges, and Clark, District Judge), in an extensive discussion of the set-off right, the court said:

> "So, courts of equity of the United States have been

peculiarly alert to prevent the defeat of an equitable right of set-off by the interposition of assignments, receiverships or statutory liquidations, and to extend the right whenever there appeared any substantial equity in favor of the claim."

In *First Nat'l Bank vs. Malone*, 76 Fed. (2d) 251 (8 C. C. A.), the court, discussing the equitable origin and nature of set-off and its accomplishment of justice, said:

"While the doctrine was originally 'a mere procedural convenience, it has now become 'really a requirement of substantive justice.'"

In *Wisdom vs. Guess Drycleaning Co.*, 5 Fed. Suppl. 762 (Dist. Mass.), after an extensive discussion of the set-off right, the court said:

"We have seen that the better modern view regards set-off as a substantive right."

The right has been characterized as in the nature of a lien, by this court and others. *Central Nat'l Bank vs. Connecticut, etc., Co.*, 104 U. S. 54; *Goodwin vs. Barre Savings, etc., Co.*, 91 Vt. 286; *Andrew vs. American Savings Bank*, 218 Iowa 489; see, also, *Champlin Refining Co. vs. Gasoline Products Co.*, 29 Fed. (2d) 331, 338 (1 C. C. A.); *In re W. & A. Bacon Co.*, 261 Fed. 109, 111 (Dist. Mass.).

In its essence, set-off is the right of A to withhold payment of his debt to B and to apply it, *pro tanto*, upon B's debt to him. Its nature is such that if A is compelled to pay his debt to B, the set-off right is gone, and he then has only his wholly unsecured claim against B. *In short, the denial or staying of its exercise, when B sues A, is necessarily a complete destruction of the right.* This characteristic should be clearly kept in mind in the consideration of the questions here certified.

B. THE RIGHT ARISES AND EXISTS CONCURRENTLY WITH THE INCEPTION AND CONTINUANCE OF THE RELATIONSHIP OF MUTUAL DEBTORS, THOUGH ITS ENFORCEMENT MAY BE SUBJECT TO CERTAIN CONDITIONS.

It seems quite evident that the set-off right accrues when mutuality of debts arises though it may not be enforcible until certain conditions later occur. The creation of the contractual relationship in case of a pledge or mortgage gives rise to the lien, though it is not enforcible until default. The conditioning of the right to foreclose or enforce either a contractual or a set-off lien upon certain events does not negative, but rather presupposes its prior existence.

These conclusions are implicit in the decision in *North Chicago Rolling Mill Co. vs. St. Louis Ore & Steel Co.*, 152 U. S. 596. In that case, A had sued B and garnisheed C. At the time of garnishment there existed a contract between B and C. Subsequently, C sued A to restrain A from enforcing the garnishment until damages claimed by C from B under that contract had been ascertained and set off against C's debt to B. This court sustained C's right to such injunction as against a claim by A that the right of set-off had not arisen until after the garnishment. This court said in part:

> "The material thing is that the contract (for the breach of which the claim for damages arises) was in existence when the garnishment process was served."

And again:

> "It is sought to defeat this right of the Chicago Company by invoking in favor of the Joliet Company, and its assignee, Ferguson, the doctrine of relation so as to antedate the claim for damages. This cannot be done

for two reasons: first, because the breach of contract, on which the claim for damages is based, had in fact commenced before the garnishment writ was served; second, if that had not been the case, the contract, for the non-performance of which the right for damages arises, was in existence when the garnishment proceedings were instituted.

This unquestioned fact is very material, if not controlling of the case. The court below did not give the fact that the claim for damages arose under and by virtue of a contract in existence prior to the date of the attachment its due weight and importance as will be seen by a brief reference to the authorities bearing upon the question."

Citing with approval state court decisions reaching a like conclusion, the court spoke of one as "allowing a set-off which matured after action brought," and said:

"In other words, the principle established by these cases is that whatever rights the garnishee may have under existing contracts with the principal debtor, he is entitled to have the benefit thereof as against the attaching creditor."

As hereinafter observed, Questions 1 and 2 are broad enough to permit assumption of facts found below establishing that the existence of the deposit account and the bank's ownership of the bonds antedated not only the filing of the petition under §77 but also the enactment of that statute. The materiality of such a permissive hypothesis upon certain contentions will be later discussed.

II.

Question 1. The Right of Set-Off Recognized by Section 68 (a) of the Bankruptcy Act Should Be Held to Apply to Reorganization Proceedings Under §77 of That Act.

A. Under Provisions of the Bankruptcy Act Antedating §77, the Title of the Debtor, Passing to the Trustee, Has Long Been Subject to Valid Liens, Including the Right of Set-Off.

Certain provisions of the Bankruptcy Act, and their sequence, should be noted.

Section 67 provides:

"(a) Claims which for want of record or for other reasons would not have been valid liens as against the claims of the creditors of the bankrupt shall not be liens against his estate.

* * * * * * * * *

(d) Liens given or accepted in good faith and not in contemplation of or in fraud upon the provisions of this title, and for a present consideration, which have been recorded according to law, if record thereof was necessary in order to impart notice, shall, to the extent of such present consideration only, not be affected by anything herein."

Section 68 provides:

"Set-offs and counterclaims. (a) In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and

one debt shall be set off against the other, and the balance only shall be allowed or paid.

(b) A set-off or counterclaim shall not be allowed in favor of any debtor of the bankrupt which (1) is not provable against the estate; or (2) was purchased by or transferred to him after the filing of the petition, or within four months before such filing, with a view to such use and with knowledge or notice that such bankrupt was insolvent, or had committed an act of bankruptcy."

Section 70 provides:

"(a) The trustee of the estate of a bankrupt, upon his appointment and qualification, and his successor or successors, if he shall have one or more, upon his or their appointment and qualification, shall in turn be vested by operation of law with the title of the bankrupt, as of the date he was adjudged a bankrupt, except in so far as it is to property which is exempt."

Under these sections, it has uniformly been held that the trustee's title is subject to all valid liens and equities of creditors or other parties. This principle is not affected by the amendment of June 25, 1910, c. 412, §8, vesting the trustee with the rights, remedies and powers of a judgment creditor holding an unsatisfied execution, for the rights of such a creditor are necessarily subordinate to valid liens and equities of third persons. The principle applies not only in cases of bankruptcy but in receiverships and like proceedings. Cases expressly recognizing the principle, include the following: *In re Searles,* 200 Fed. 893 (E. D., N. Y.) (bankruptcy proceedings); *Scott vs. Armstrong,* 146 U. S. 499 (liquidation of national bank); *Central Appalachian Co. vs. Buchanan,* 90 Fed. 454 (6 C. C. A.) (equity receivership).

The principle is necessarily recognized in the numerous decisions which have uniformly sustained the right of set-off in actions brought by trustees against debtor-creditors. 4 *Remington on Bankruptcy,* 4th Ed., §1451, at p. 217, and §1473, p. 249. It would require no discussion here except for the assumption of appellants that recognition and enforcement of the set-off right under §77 would be equivalent to a withdrawal, *pro tanto,* of property available for reorganization plans (App. Br., pp. 13, 15, 17). This assumption is erroneous unless it be assumed that as to set-off, at least, §77 departs from the long established bankruptcy concept that, as to secured creditors, all that passes to the bankruptcy estate is the debtor's equity. That assumption is the very point at issue. At the time of the filing of the petition, the railroad did not have an absolute right to the deposit account. The account was subject to the possessory set-off lien. Upon or after the filing of the petition, no absolute right to the account became vested in the railroad's estate, or the subsequently appointed trustees, unless §77 be construed as abrogating the set-off right upon such event and unless, as so construed, such provision is valid. Therefore, to say that §77 should be so construed because the exercise of the set-off right would withdraw assets otherwise vested in the bankruptcy estate leads nowhere. The immediate question is simply whether §77 is to be construed as vesting in the estate an absolute title free from the set-off lien to which it would remain subject in proceedings under the general provisions of the Act.

B. A Proper Construction of §77 Requires the Conclusion That the Substantive Right of Set-Off Was Not Thereby Abrogated.

This conclusion was reached by the District Court below, 11 Fed. Suppl. 929; likewise, by the District Court for Iowa in an action by the same trustees, *Lowden, et al., vs. Iowa-Des Moines National Bank,* 10 Fed. Suppl. 430. A like conclusion was reached by the District Court for the Southern District of New York, under §77B and subdivision (k) thereof, in *Re Associated Telephone Utilities Co.,* 12 Fed. Suppl. 468. For the reasons next herein discussed, we submit that the conclusions of these courts are correct and that the contrary construction here urged cannot be sustained.

1. *The exercise of the set-off right is consistent with the provisions of §77 and hence affirmatively preserved by subdivision (n) thereof.*

Subsequent contentions aside, it would seem that subdivision (n) of §77 is alone decisive as to the point involved. That subdivision provides:

> "In proceedings under this section and consistent with the provisions thereof, the jurisdiction and powers of the court, the duties of the debtor and the rights and liabilities of creditors, and of all persons with respect to the debtor and his property, shall be the same as if a voluntary petition for adjudication had been filed and a decree of adjudication had been entered on the day when the debtor's petition was filed."

Unless preservation of the set-off is inconsistent with *the provisions* of §77, it is not thereby abrogated.

There is no provision in §77 denying the set-off right or

even mentioning it. There is nothing providing for destruction of substantive rights or liens of creditors of any class. The preservation of that right presents no inconsistency or repugnancy, inherent or otherwise, with any of the actual provisions of §77. A construction preserving the set-off right under subdivision (n) does not nullify any other express provision of the section.

There are certain suggestions of inconsistency of §68 with specified provisions of §77, briefly stated at pages 15-18 of appellants' brief.

It is there said that the allowance of the set-off right by the bank would give it a "preference" over other holders of the same issue of bonds, that a preference is generally denounced by §77 and that subdivisions (c) to (g), inclusive, require like treatment of all creditors. The assumption of a preference is clearly fallacious. A similar argument that allowance of set-off is bankruptcy or like proceedings has twice been clearly rejected by this court. In *New York County Bank vs. Massey*, 192 U. S. 138, this court, in sustaining the set-off right under §68, said:

> "It is true that it creates a debt, which, if the creditor may set it off under §68, amounts to permitting a creditor of that class to obtain more from the bankrupt's estate than creditors who are not in the same situation, and do not hold any debts of the bankrupt subject to set-off. But this does not, in our opinion, operate to enlarge the scope of the statute defining preferences so as to prevent set-off in cases coming within the terms of §68a. If this argument were to prevail, it would, in cases of insolvency, defeat the right of set-off recognized and enforced in the law, as every creditor of the bankrupt holding a claim against the estate subject to reduction to the full amount of a debt due the bankrupt re-

ceives a preference in the fact that, to the extent of the set-off, he is paid in full."

In *Scott vs. Armstrong,* 146 U. S. 499, in sustaining a set-off in a national bank liquidation, this court said:

> "Where a set-off is otherwise valid, it is not perceived how its allowance can be considered a preference, and it is clear that it is only the balance, if any, after the set-off is deducted which can justly be held to form part of the assets of the insolvent. The requirement as to ratable dividends, is to make them from what belongs to the bank, and that which at the time of the insolvency belongs of right to the debtor does not belong to the bank."

It is just as clear that allowance of the set-off under the facts here certified would not constitute a preference as to other holders of the railroad's bonds. The mere fact that the bank, unlike other bondholders, has by other transactions wholly unrelated to the trust indenture, acquired an additional security in the nature of a set-off right, in no way makes the exercise of that right a preference over other bondholders. Accordingly, the above mentioned suggestion of inconsistency of §68 with §77 is wholly groundless.

Appellants also state that §68 is inconsistent with subdivision (j) of §77 because the latter provides that upon confirmation of a reorganization plan "the property of the debtor" shall be free from all claims, etc. (App. Br., p. 17). As a matter of fact, subdivision (j) refers to the "property dealt with by the plan." If §77 does not abrogate the set-off right, then the bank account, so far as subject thereto, is not property to be "dealt with by the plan"; it belongs to the one possessed of the set-off right. In *Scott vs. Armstrong, supra* (hereinafter noted at more length), in answering a like contention that provisions in the act for

liquidating insolvent national banks, as to ratable distribution of assets of the bank, precluded the right of set-off against such assets, this court held that the distribution of dividends were to be made only

> "from what belongs to the bank and that which at the time of insolvency belongs of right to the debtor does not belong to the bank."

Hence, just as in that case the assets of the insolvent bank available for ratable dividend distribution could not include assets belonging to others under the set-off right, so here, the property to be dealt with on reorganization cannot include assets belonging to others under the set-off right, unless §77 be construed as destroying that right. Again, that is the very point here at issue. Subdivision (j) of §77 does not attempt to state what property shall be dealt with by the plan. It does not say that choses in action upon which a debtor-creditor has a possessory or analogous lien shall be dealt with free from that lien. It is patent that said subdivision is not inconsistent with §68. It is not nullified by the exercise of the set-off right under §68. It operates, as previous provisions of bankruptcy or insolvency acts concerning administration of assets have operated, only upon the titles or equities otherwise vested in the bankrupt or insolvent estate, or its trustees.

It is clear, therefore, that it cannot be concluded that the set-off right is denied by §77 because its exercise would be inconsistent with any actual provisions of the act. Nowhere does the act provide for its denial. No provision is nullified by its exercise. The essence of appellants' argument is that §68 is inconsistent, not with the provisions, but with the purposes of §77 (App. Br., pp. 5-6, 8-16, etc.). That will be shortly discussed. But, immediately, we insist that *in the absence of inconsistency of §68 with actual provisions*

of §77, subdivision (n) of the latter is controlling. As Judge Nordbye, below, said:

> "But we are confronted with the unambiguous language contained in subsection (n) of Section 77 to the effect that the rights and liabilities of creditors with respect to the debtor and his property shall be the same as if a voluntary petition had been filed and the debtor adjudicated a bankrupt. It is fair to assume that, in so far as it may be consonant with the general provisions of Section 77, Congress intended by subsection (n) to fix the status of the parties as to their rights and liabilities with reference to liens, preferences, etc., as would have resulted in the event there had been an adjudication." (11 Fed. Suppl. 929, at 935.)

And again:

> "A deposit in a bank under the circumstances herein simply creates an ordinary debt. If there is no inconsistency between the right of set-off and the provisions of Section 77, and if subsection (n) is to be construed literally, it seems reasonably clear that the rights of the bank on June 7th are to be determined in the same way as if the Rock Island had been adjudicated a voluntary bankrupt." (11 Fed. Suppl. 929, at 936.)

In the Iowa case between the same trustees and the Des Moines bank, Judge Dewey said:

> "Section 77 expressly provides that provisions of the general Bankruptcy Act which are consistent with the provisions of Section 77 shall control the rights and liabilities of the creditors; and Section 68 of the Bankruptcy Act expressly permits set-offs and counterclaims. In the absence of any provision in Section 77 limiting this right of set-off, I can see no reason why creditors are not entitled to the same rights with respect to set-

off of mutual debts and credits as they would have had the Railway Company invoked the general bankruptcy laws." (10 Fed. Suppl. 430, at 432.)

2. *The contended contrary construction rests upon the inadequate basis of implication from an assumption of the general purposes of* §77.

In the light of the affirmative provisions of subdivision (n), we do not concede that discussion or conjecture as to whether abrogation of the set-off right under §68 was one of the purposes or intended effects of §77, is in order. If the Congress had intended to abrogate, it could, and should have expressly so provided. If it had intended to overthrow any substantive right so long established and so favorably recognized and extended by courts of equity, it should have so declared in plain terms. If it had intended to enact such a radical departure from the policy of bankruptcy statutes as to legislate out of existence, established lien or security rights, such intent should not have been left to speculative implication.

The historic prevalence of the right in bankruptcy legislation is emphatically noted in *Carr vs. Hamilton,* 129 U. S. 252. The historic policy of American bankruptcy legislation in avoiding actual impairment of valid liens or substantive rights is emphasized in *Louisville Joint Stock Land Bank vs. Radford,* 295 U. S. 555, at 583, 589. It is a cardinal rule of construction that neither firmly established principles of law nor long recognized legislative policy is to be abrogated by mere implication of such intended purpose or result. *Robertson vs. Railroad Labor Board,* 268 U. S. 619; *Panama R. R. Co. vs. Johnson,* 264 U. S. 375.

In the absence of provisions expressing such intent, coun-

sel, of necessity, have been remitted to the contention that the set-off right is not consistent with the "purposes" of §77; hence its intended abrogation must be implied. Discussion is unnecessary to emphasize that whether we talk of contracts or of statutes, there is a wide difference in fact and in law between actual provisions, on the one hand, and purposes, whether recognizable or arguable, on the other. Parties to a contract, or legislative bodies, may have a purpose, even clearly beyond dispute, but they may omit to make the actual provisions necessary to give effect thereto. Here, the claim as to purpose is purely nebulous. No one can assert that Congress intended specifically to abrogate the set-off right. It is simply argued that because of certain declared purposes as to permitting reorganizations, it must be further speculated that Congress must have intended to abrogate a specific and long-established right although it made no provision for its abrogation. By what concept of construction it is claimed such an undeclared and unestablished "purpose" can, by implication, override the express terms of subdivision (n) is not even suggested. The decision of this court in *Scott vs. Armstrong, supra,* rejecting a like contention that the set-off right was impliedly abrogated by the Acts of Congress providing for the method of liquidation of insolvent national banks seems to us conclusive here. In an attempt therein to defeat the exercise of the set-off right it was argued that certain provisions of the act there involved contemplated ratable distribution of assets among all creditors. In rejecting the contention the court said:

> "The argument is that these sections by implication forbid this set-off because they require that after the redemption of the circulating notes has been fully provided for, the assets shall be ratably distributed among

the creditors, and that no preferences given or suffered, in contemplation of or after committing the act of insolvency, shall stand. And it is insisted that the assets of the bank existing at the time of the act of insolvency include all its property without regard to any existing liens thereon or set-offs thereto.

We do not regard this position as tenable. * * * liens, equities, or rights arising by express agreement, or implied from the nature of the dealings between the parties, or by operation of law, prior to insolvency and not in contemplation thereof, are not invalidated. The provisions of the Act are not directed against all liens, securities, pledges, or equities, whereby one creditor may obtain a greater payment than another, but against those given or arising after or in contemplation of insolvency."

Referring to the long established recognition of set-off in the English Bankruptcy Acts, the court continued:

"The succeeding statutes were but in recognition, in bankruptcy and otherwise, of the practice in chancery in the settlement of estates, and it may be said that in the distribution of the assets of insolvents under voluntary or statutory trusts for creditors the set-off of debts due has been universally conceded. The equity of equality among creditors is either found inapplicable to such set-offs or yields to their superior equity.

"We are dealing in this case with an equitable set-off, but if on June 20th the note had matured and each party had a cause of action capable of enforcement by suit at once, upon the argument for the receiver the legal set-off would be destroyed just as effectually as it is contended the equitable set-off is. *We cannot believe Congress intended such a result, or to destroy by*

implication any right vested at the time of the suspension of a national bank." (Italics ours.)

It therefore seems to us that appellants' argument that an intent to abrogate the set-off right should be implied because its exercise might, in certain assumed instances, hamper the accomplishment of a reorganization plan, merits no discussion. However, we shall briefly examine it. Reduced to its essence, the argument is that *if* a given railroad had all or the bulk of its working capital on deposit in banks, and *if,* in turn, these several banks happened to own the railroad's bonds in amounts aggregating all or a large part of such deposits, allowance of the set-off right rendering such funds unavailable for operation or reorganization *might prevent* the accomplishment of any reorganization as contemplated by §77. In an attempt to illustrate those hypotheses, counsel step outside the record (App. Br., p. 13). Even then, it is noteworthy that there is no assertion that the fifty Rock Island bank depositaries held bonds which might be a basis for set-off. It must be quite patent that the situations wherein there would be mutuality of debts as between carriers and others would be rare. If the dangers had actually been as great and fearful as here urged by counsel, and if Congress had so thought and had intended to avert them, there can be little doubt that clear and specific provisions against that result would have been made. It may not be amiss to note, in passing, that such right had been exercised by two of the banks involved in the main Rock Island case, *Continental Ill. Nat. Bank vs. C., R. I. & P. Co.,* 294 U. S. 648; yet no one indicated any of the apprehension here voiced by counsel. In note 2 at page 659, a tabulation is given showing that the total loans of the five banks whose sale of collateral was enjoined amounted to $4,125,000.00. The note further states that:

"The $4,125,000.00 was reduced to $3,866,923.34 by application of debtors' deposits in the Continental and Mississippi Valley Banks."

Yet the assumption of counsel and the Court seems clearly to have been that a plan of reorganization would be successfully worked out. The calamity argument here urged not only assumes that the contended construction can be reached by implication, but also presupposes a real and general hazard, its recognition by Congress, and an intent to avert it. Upon the record, none of these assumptions has any factual or legal basis. The record contains no facts establishing the hazard. Nothing indicates its recognition by Congress. The act contains no express provisions evidencing the assumed intent.

We may go a step further. In the *Continental Bank case,* 294 U. S. 648, it appeared that securities aggregating $200,000,000.00 belonging to the Rock Island (294 U. S., at 678) were pledged to various creditors. Such securities, if discharged of the pledge liens, would have constituted assets of the railroad and a source of funds available for operation and for consummation of a reorganization plan. While this court held that a sale of such securities by the pledgees might temporarily be stayed, it did not hold nor has it been claimed that §77 abrogated or was intended to abrogate the substantive security right of such pledgees. Yet the same arguments advanced by appellants for implied abrogation of the right of set-off apply with equal force to other security rights. Even upon the erroneous assumptions involved in appellants' hypothesis there is no more reason for implying, as to §77, a repeal or nullification of §68 preserving that set-off right in bankruptcy, than there is for implying a repeal or nullification of §67 (d) preserving other valid lien rights. And in the *Continental Bank case,* this

court clearly implied the continuing application of §67 (d) in proceedings under §77, saying:

> "The injunction does not infringe §67 (d), U. S. C. Title 11, §107 (d)." (294 U. S., at 676.)

Upon what basis can it be inferred that Congress intended to discriminate? Wherein lies the foundation for the contention that Congress intended to carry forward into §77 the protection of liens under §67 (d) but to withhold the protection of the set-off right under §68? None of the gratuitous hypotheses advanced suggest any basis for such arbitrary discrimination.

Appellants invoke a decision of the same court which certified the questions here presented—*Grand Boulevard Investment Co. vs. Strauss,* 78 Fed. (2d) 180 (App. Br., pp. 21-2). It is claimed that the decision therein requires the conclusion that the possessory lien or set-off is not preserved by §77. Obviously, the Eighth Circuit Court did not consider its decision therein as requiring such conclusion; otherwise it would hardly have certified Question 1 here. That opinion merely decided that the discretionary power under §77B to suspend remedial rights included the power to require a mortgagee in possession to surrender possession. The mortgagee's right of possession was merely one of its remedial rights. The decision relied upon, but went no further than the decision of this court in the *Continental Bank case.* Neither case involved or inferentially sanctioned any abrogation or destruction of the substantive security right. On the contrary, both decisions carefully noted that the substantive rights of the lien holder were not impaired. Appellants' attempted comparison by reason of the fact that in the case here certified the bank was in possession (as was the mortgagee in the *Grand Boulevard case)* wholly fails, because *as to the possessory lien of set-*

off, a required surrender of possession necessarily destroys the lien.

We submit that in the absence of express provision to the contrary, not only is the right of set-off clearly preserved by subdivision (n) of §77 but also that the claim of its abrogation cannot be sustained upon the resort to implication.

3. *Other provisions of §77 require the conclusion that there was no intent to abrogate the set-off right.*

Appellants have noted the provisions of subdivisions (c) to (g), inclusive, of §77. We have already discussed their contention that allowance of set-off would constitute a preference contrary to the intent of these provisions. A further consideration of these provisions leads to the conclusion that rejection of the set-off right would violate these very provisions.

It is clearly a fundamental concept of §77 that creditors shall be classified and that all in a given class shall be treated fairly and without discrimination. It is just as clear that appellants' contention would flatly violate this concept by totally destroying a security right otherwise possessed by defendant.

Briefly summarized, subdivisions (c) to (g-1) contemplate a division of creditors into appropriate classes and forbid discrimination as between them. Sub-paragraph 6 of subdivision (g) further requires that any reorganization plan must provide

> "adequate protection for the realization by them of the value of their securities, liens and claims."

Under the authorities heretofore noted, a creditor possessed of a set-off right is not an unsecured creditor. His

is a security right—more valuable and efficient than a lien evidenced by a mortgage or pledge because no legal machinery and no delay is involved in its enforcement. *Its nature is such that if its recognition is denied when the creditor is sued by the trustee, the right is totally destroyed.* To be sure, the creditor's claim may persist, but only as an unsecured claim; the security right, however, is gone. This was recognized by Judge Nordbye, below:

> "If this Court should now deny the defendant the right of set-off and require the bank to turn over this deposit to the trustees, the bank would be left in a position whereby it could never exercise its right of offset in the reorganization proceeding."
>
> (11 Fed. Suppl. 929, at 935.)

While the *Continental Bank case* holds that proceedings to enforce pledges may be temporarily suspended under §77, the opinion of this court makes it clear that the substantive lien right cannot be destroyed. 294 U. S. at 677-8, 681. Are we then to say that, of necessity, the substantive set-off right must be destroyed—that such was the intent of §77? The provisions cited clearly indicate the contrary. "Adequate protection for the realization by them (creditors) of the value of their securities, liens and claims" is just as much of the essence and spirit of §77 as the accomplishment of a reorganization. No one can say that §77 contemplates that the sole aim and purpose of §77 is a successful reorganization, to be accomplished at all hazards. No one can say that it was thereby intended that the desired end result be reached by confiscation of substantive security rights of creditors. To the extent that such an intent or effect is attributed by counsel to §77 important constitutional questions are presented which not only prevent such construction but which preclude such a result.

4. Appellants' contended construction presents reasonable and serious doubts as to constitutionality.

It is a basic rule that statutes must be construed not only to prevent unconstitutional results, but also results presenting reasonable doubts as to constitutionality. *Knights Templar, etc., Co. vs. Jarman,* 187 U. S. 197, 205; *Carey vs. South Dakota,* 250 U. S. 118, 122; *Harriman vs. I. C. C.,* 211 U. S. 407, 422; *Fed. Tr. Com. vs. Am. Tobacco Co.,* 264 U. S. 298, 307.

We contend that if and to the extent that it might be assumed that §77 provided or by implication effected an abrogation of the set-off right, the act would be unconstitutional. Immediately, we submit that the contended construction would at least present reasonable doubts as to constitutionality; and that alone precludes the adoption of such construction. The next succeeding discussion will present our claims as to unconstitutionality, and, of necessity, our contentions as to constitutional doubts. To avoid repetition, we therefore proceed to the next phase of our argument.

C. If §77 Be Construed as Providing Abrogation of the Set-Off Right It Is Violative of the Fifth Amendment.

From the argument heretofore set forth we believe that §77 cannot properly be construed as abrogating the set-off right. If the court reaches that conclusion, Question 1 must be answered in the affirmative and without qualification. If a contrary construction be adopted, we nevertheless submit that the answer to Question 1 must still be in the unqualified affirmative for the reasons now to be considered.

In *Louisville Joint Stock Land Bank vs. Radford*, 295 U. S. 555, it was recognized and held that the bankruptcy power of Congress is subject to the Fifth Amendment. The court therein further held that provisions of the Frazier-Lemke Act, which substantially impaired the substantive lien rights of a mortgagee, were, for that reason, violative of the Fifth Amendment and not sustainable as permissive bankruptcy legislation. The court pointed out that prior to the statute there involved

> "No bankruptcy act had undertaken to modify in the interest of either the debtor or other creditors any substantive right of the holder of a mortgage valid under federal law."

And again that

> "the Frazier-Lemke Act is the first instance of an attempt, by a bankruptcy act, to abridge, solely in the interest of the mortgagor, a substantive right of the mortgagee in specific property held as security."

A like conclusion of invalidity of bankruptcy legislation destroying substantive rights seems implicit in the decision in the *Continental Bank case* sustaining the power under §77 to suspend temporarily the remedial enforcement of lien rights. In that case the court said:

> "The injunction here in no way impairs the lien, or disturbs the preferred rank of the pledgees. It does no more than suspend the enforcement of the lien by a sale of the collateral pending further action." * * *
>
> "The injunction here goes no further than to delay the enforcement of the contract." * * * *

And, again:

> "* * * we understand that the injunction may at any time be dissolved upon application and proper no-

tice and showing. It contemplates, as we have already suggested, only reasonable delay."

It may be suggested that the Frazier-Lemke Act expressly limited its application to pre-existing mortgages and that the scope of the decision in the *Radford case* is correspondingly limited. With respect to any such suggestion, we submit:

1. That within such limitations the *Radford* decision would at least require a qualified answer to Question 1, sustaining the set-off right under §77 at least in cases where the right had its origin prior to the enactment of §77.

2. That even a prospective operation of the contended abrogation of the set-off right under §77 would be unconstitutional; hence, an unconditional affirmative answer to Question 1 is still required.

1. *If §77 be construed as abrogating the set-off right, it violates the Fifth Amendment as to such rights accrued before its enactment.*

This is the essence of the *Radford* decision as to the lien rights of a mortgagee. It would seem inescapably applicable as to the possessory lien of the set-off right. If the court should accept appellants' contention as to the implied intent of §77, we submit that, in any event, Question 1 cannot be answered in the negative in so far as it may be attempted to apply that intent to rights of set-off originating prior to the enactment of §77.

We do not intend to offend any rule against excursion outside of the facts here certified. We do feel, however, that we may, with propriety, mention certain facts found by the

court below, as appearing in the reported decision, merely to illustrate the occasion for qualification of any possible negative answer to Question 1.

The deposit account had been maintained "for many years prior to June 7, 1933"—the date of the reorganization petition (11 Fed. Suppl., at 930). The railroad bonds in question had been acquired by the bank upon different dates in 1927, 1928 and 1930 (11 Fed. Suppl., at 931). Section 77 became effective March 3, 1933. Accordingly, the relationship of mutual debtors, as between the railroad and the bank, had originated long before §77 and existed at the time of its enactment. Upon such an hypothesis, permissible under Question 1, that question may involve a decision here as to whether §77, if intended to deny the set-off right, is constitutionally valid in so far as such denial would extend to set-off rights existing at the time of enactment, whether or not the rights had then become enforcible. Under the *Radford* decision, we submit that Congress could not constitutionally destroy such a substantive lien right.

If this court should conclude that §77 impliedly provides for destruction of the set-off right and should further conclude that such provision is valid as to such rights subsequently arising, we still submit that any negative answer to Question 1 would necessarily be qualified, at least, to recognize that such abrogation cannot extend to previously originating and existing set-off rights.

2. *Even a prospective operation of such implied intent to abrogate would be unconstitutional.*

As to a mortgage lien, this contention was advanced, mentioned but not decided in the *Radford case* (294 U. S., at 578, 589).

In the first place, it must be clear that Congress could not constitutionally legislate the set-off right out of existence. It could not decree that the right should never exist or be exercised or judicially recognized. It could not thus encroach upon the powers reserved to the states as to rights arising out of ordinary business or commercial dealings. The set-off right, independent of the Bankruptcy Act, exists and is recognized by the Minnesota courts and by the Eighth Circuit Court of Appeals. *Wallrick vs. Hall,* 19 Minn. 383; *Sweetser vs. Peoples Bank,* 69 Minn. 196; *Habegger vs. First Nat'l Bank,* 94 Minn. 445; *First Nat'l Bank vs. Malone,* 76 Fed. (2d) 251 (8 C. C. A.).

Can Congress, then, under its bankruptcy power, prospectively provide that such a right, thereafter validly arising and existing, shall be denied recognition, and therefore shall be confiscated, in the event of bankruptcy? Could it so provide as to liens subsequently arising under express contract or valid statutes? The absence of authority upon the point is undoubtedly explained by the observations in the *Radford case* that prior to the Frazier-Lemke Act no bankruptcy statutes had ever attempted to impair substantive lien or security rights.

The bankruptcy power is subject to the Fifth Amendment. Destruction of substantive rights, even under the bankruptcy power, is thus forbidden. Since Congress has no power to prevent the creation of lien rights, whether by way of pledge, mortgage, set-off or otherwise, it seems clear that it cannot

provide that bankruptcy proceedings of any type shall operate to destroy such rights validly created—and this, whether the rights are created before or after its enactment attempting so to do. When there is acceptance of the necessary premise that the right is validly in existence when the bankruptcy proceedings are initiated *(ante,* Part I), then its complete rejection in those proceedings is a taking of property even as to such rights arising after such an enactment; and, we submit, a taking without due process. And, we believe, it can be said also that such an enactment would violate the Fifth Amendment in another respect. It is not here contended that §77 contemplates abrogation of other security liens. The *Continental Bank* decision clearly indicates that such liens are preserved in their substantive aspects. The contended construction therefore involves a claim that §77 prospectively abrogated the possessory set-off lien while preserving other liens. We submit that the concept of due process under the Fifth Amendment is broad enough to include the equal protection which the Fourteenth Amendment affords against state legislation (Cf. *U. S. vs. Yount,* 267 Fed. 861, Dist. Pa.). It seems clearly repugnant to fundamental law to say that Congress, in bankruptcy legislation or otherwise, may provide for confiscation of one type of substantive liens while preserving others.

We submit that even as to set-off rights arising subsequent to §77 that act, if construed as providing for their abrogation upon initiation of reorganization proceedings, would be violative of the Fifth Amendment. This, then, would still require an affirmative answer to Question No. 1.

Conclusions as to Question No. 1.

Briefly summarizing, we submit that Question 1 should be unqualifiedly answered in the affirmative because:

1. A proper construction of §77 requires the conclusion that the substantive right of set-off was not thereby abrogated—

   (a) Its application is consistent with the provisions of §77 and it is therefore affirmatively preserved by subdivision (n).

   (b) The contrary claim rests entirely upon conjectural implication from assumed purposes of §77.

   (c) Specific provisions of §77 contemplate preservation of all substantive lien rights.

   (d) The contrary construction presents reasonable doubts as to constitutionality.

2. If §77 were to be construed as intending or providing abrogation of the set-off right, it would, to that extent, violate the Fifth Amendment.

III.

Question 2. If the First Question Be Answered in the Affirmative, Can a Bank Which Owns the Unmatured Bonds of a Railroad Corporation Set Off a Deposit Account of the Railroad With the Bank Against the Bonds, Upon the Filing by the Railroad of a Petition for Reorganization Under Section 77 of the Bankruptcy Act, Alleging That the Railroad Is Unable to Meet Its Debts as They Mature.

Some of the cases indicate that in actions other than those arising out of bankruptcy proceedings a set-off right or lien obtaining as between mutual debtors is not enforcible in such a suit unless the debt has matured, or if not matured, unless insolvency exists. *Scott vs. Armstrong,* 146 U. S. 499; *Schuler vs. Israel,* 120 U. S. 506; *Wunderlich vs. Bank,* 109 Minn. 468; *Storing vs. Bank,* 28 Fed. (2d) 587 (8 C. C. A.).

For reasons next discussed, we submit that neither of these alternative requisites for the enforcement of the right obtain under §68; and if the contrary be held, that either or both of such requisites are within the purview of Question 2.

A. Neither Insolvency Nor Maturity of the Debt Essential to Exercise of the Right Under §68.

1. *Insolvency not essential under §68.*

It should first be noted that *there may be bankruptcy proceedings under the general provisions of the Act, even though there be no insolvency as defined in subdivision 15 of section 1 thereof. George M. West Co. vs. Lea Brothers & Co.,* 174

U. S. 590; *In re Cohn,* 227 Fed. 843 (certiorari denied, *Blumenthal vs. Strat,* 241 U. S. 662); *In re C., R. I. & P. Ry. Co.,* 72 Fed. (2d) 443, 450; *In re Hargadine, etc., Co.,* 239 Fed. 155 (Dist. Mo.); *In re Dressler, Producing Corp.,* 262 Fed. 257 (2 C. C. A.); 1 *Remington on Bankruptcy* (4th Ed.), §48; 11 U. S. C. A., Sec. 21, note 2—p. 177, note 82—p. 213, note 132—p. 235, and numerous cases cited.

Appellants' statement that this court has never so held (App. Br., p. 27) is in error. *(George M. West Co. vs. Lea Brothers, supra.)* Under the terms of §3 of the Act, and the cases above cited, insolvency is not a prerequisite to involuntary bankruptcy proceedings based upon fraudulent transfer or concealment of assets (subd. a-1), a general assignment for the benefit of creditors (subd. a-5), or an admission of inability to pay debts (subd. a-6, section 3, as amended May 27, 1926). Under no circumstances is insolvency a prerequisite to voluntary proceedings. So, we may have a bankrupt and bankruptcy proceedings even though there be no insolvency within the definition of subdivision 15 of Section 1, or otherwise.

If we turn to §68 of the Bankruptcy Act, we find that it contains no provisions whatsoever, limiting its application to cases where insolvency exists. Its language clearly excludes any such limitation. It provides that

> "in all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor * * * one debt shall be set off against the other."

Upon the assumed affirmative answer to Question 1, section 68 applies to all bankruptcy proceedings, both under the general provisions of the Act and under §77. Therefore, the set-off right exists in proceedings based upon fraudulent transfers, general assignments and confessed inability to

pay debts even when there is no insolvency, as defined in section 1. Perforce, it must exist in proceedings under §77 though there be no insolvency as defined in section 1. Therefore, there is no basis for importing into §68, in its application under §77, any requirement of insolvency in the sense of deficiency of assets as compared to liabilities.

It may be noted that under subdivision a-6 of section 3 of the Act (11 U. S. C. A., §21, as amended May 27, 1926), there may be bankruptcy proceedings if a debtor has

> "admitted in writing his inability to pay his debts and his willingness to be adjudged a bankrupt on that ground."

Such proceedings could be had and the right of set-off under §68 could be exercised therein, regardless of insolvency under section 1. In the second question certified we have a like situation under §77—the carrier's petition declaring in writing its inability to pay its debts and its willingness to subject itself to these new provisions of the Bankruptcy Act. Assuming, as does Question 2, that the set-off right persists under §77, there would seem to be no basis or reason for conditioning its exercise upon insolvency under section 1, when clearly that condition is not required in like circumstances under the general provisions of the Act.

2. *Maturity not essential under §68.*

As noted, subdivision (a) of §68 expressly provides for recognition of set-off "in *all cases* of mutual debts or mutual credits." The sole limitations are stated in subdivision (b), denying it as to a debt "not provable against the estate" and as to claims acquired under circumstances not here material. By necessary inference, especially with the broad scope of subdivision (a), a debt that is provable may be set off.

It is well settled that debts not matured are nevertheless provable.

11 U. S. C. A., §103, note 14, p. 45, and cases cited.

It is equally well settled that under §68, debts not matured may nevertheless be set off.

11 U. S. C. A., §108, note 3, p. 260, and cases cited.

This was early recognized by this court in *Carr vs. Hamilton*, 129 U. S. 252, wherein it is said:

> "principle of set off between mutual debts and credits * * * has always prevailed in our own (bankruptcy laws) * * * and it mattered not whether the debt was due at the time of bankruptcy or not."

In *Germania Savings Bank, etc., vs. Loeb*, 188 Fed. 285 (6 C. C. A.), it is said:

> "The word 'debt,' as used in section 68a includes any debt provable in bankruptcy. * * * And a debt is provable, whether due or not at the time of bankruptcy. Bankr. Act. 1898, §63a (1). *It is thus immaterial to the application of section 68a whether or not the notes were due.*"

In *Re Philip Semmer Glass Co.*, 135 Fed. 77 (2 C. C. A.), after quoting §68 and its application to an unmatured debt, the court said:

> "To determine, therefore, whether the holder of a claim is entitled to the benefit of section 68, it is *necessary only to inquire* whether his claim is one provable in bankruptcy."

See also, *In the Matter of United Sportwear Company, Inc.*, 28 Am. Bkptcy. Rep. (N. S.) 451 (D. C. Mass., 5-20-35), wherein the court, under §77B denied the debtor's petition for a summary order for payment of a bank deposit account upon the bank's objections to summary jurisdiction to deter-

mine its right of set-off. The note claimed to be set off was not due until January 13th though the petition under §77B was filed on January 4, 1935.

The bonds in question, though not matured according to their terms, were undoubtedly provable claims under the general provisions of the Act as contemplated by subdivision (b) of §68. They were equally provable under §77 (see subdivisions b and c-5 of §77 as to allowance and provability of claims).

As heretofore noted, the right or possessory lien of set-off arises when mutuality of debts obtains. The alternative conditions of maturity or non-maturity plus insolvency are merely conditions which, in the absence of bankruptcy proceedings, may be essential pre-requisites to the right to enforce. Section 68 of the Bankruptcy Act does not prescribe such conditions as essential to enforcement in the event of bankruptcy proceedings. This alone requires an affirmative answer to Question 2.

B. If the Alternative Pre-requisites to Its Exercise in Equity Were Here Applicable, Those Requisites Are Embraced Within Question 2 or Its Permissive Assumptions.

1. *There is insolvency within the equity concept; this eliminates any possible requisite of maturity.*

There are two distinct definitions of "insolvency." One is the bankruptcy definition, in substance, of deficiency of assets as against liabilities.

Subd. 15, §1 of Bankruptcy Act (11 U. S. C. A., §1).

By its terms, this is not a definition applicable to all instances where the meaning of insolvency may be collateral-

ly involved in controversies arising by reason of bankruptcy proceedings. By its terms it is simply a statement as to when "a person shall be deemed insolvent within the provisions of this title." In other words, in so far as insolvency of the debtor is the basis for bankruptcy proceedings, subdivision 15 of Section 1 furnishes the test. On the other hand, there is insolvency within the equity concept whenever there is *inability to pay debts as they mature. Intercontinental Rubber Co. vs. B. & M. Ry. Co.,* 245 Fed. 122 (Dist. Mass.); *Fed. Reserve Bank vs. Idaho, etc., Assn.,* 8 Fed. (2d) 922 (9 C. C. A.); *Steele vs. Randall,* 19 Fed. (2d) 40 (8 C. C. A.); *American Can Co. vs. Erie P. Co.,* 171 Fed. 540 (C. C. N. Y.); *Martin vs. Hertz,* 224 Ill. 84; *Madsen vs. Burns Co.,* 108 N. J. Eq. 275.

Appellants note (App. Br., p. 28) that this Court, in the *Continental Bank case,* stated that the phrase "unable to meet its debts as they mature," as used in subdivision (a) of Section 77, "obviously means something less than a condition of 'bankruptcy' or 'insolvency' as those terms are employed" in the Act. But those terms are clearly used in subdivision (a) of §77 merely as specifying the alternative circumstances under which proceedings may be had under §77, just as "insolvent" is defined in subdivision 15 of §1 as a basis for proceedings under the general provisions, in those instances where insolvency is required. In neither subdivision of these sections is there any attempt to define insolvency as a pre-requisite to the exercise of the set-off right. It may be noted that Judge Nordbye, below, said:

> "The type of insolvency that will accelerate the maturity of an unmatured debt does not necessarily mean the application of the bankruptcy definition of insolvency." (11 Fed. Suppl., at 936.)

Inability to pay debts as they mature constitutes the equity concept of insolvency. Question 2 assuming such insolvency, the question of non-maturity is immaterial upon any theory.

2. *The bonds must be treated as matured; this eliminates any possible requisite of insolvency.*

If it should be held (contrary to the preceding contentions) that the exercise of the set-off right in bankruptcy proceedings is conditioned, in the alternative, upon insolvency or maturity, and further that insolvency within the equity concept is insufficient, still, if the bonds were matured, or to be treated as matured, the right to exercise the set-off lien still would obtain.

It should be borne in mind that a bankruptcy court acts, so far as may be proper, as an equity court. *Gilbert's Collier on Bankruptcy* (2nd Ed.), Sec. 2, p. 28; Section 2, Bankruptcy Act (11 U. S. C. A., §11); Cf. *Continental Ill. Nat. Bank & Tr. Co. vs. C., R. I. & P. Ry. Co.,* 294 U. S. 648, 676.

And, likewise, the action below was tried as an equity cause and the decree below recognized, established and confirmed the right of set-off and provided for delivery by the bank to the trustee of an equivalent amount of bonds (11 Fed. Suppl., at 932-3). That court properly dealt with set-off as an equitable issue *(ibid.,* pp. 933-7). Question 2 permits the hypothesis of facts found below, though not specifically embraced in the question. If such facts would require at least a qualified affirmative answer to the question, it seems to us proper to note them for that reason.

In its opinion the trial court said:

"It is significant to note that the railway company's petition avers that within a month from the time that

the petition was filed, the company would be faced with maturing interest considerably in excess of $2,000,000, which it could not pay, and, in addition, it would be faced with maturing bonds in a sum exceeding $140,000.00 in the spring of 1934, which it could not pay, and further stated that it was without funds to pay and discharge the aforesaid obligations and alleged that it had no means of borrowing or securing funds. The entire bond issue maturing April 1, 1934, excepting certain payments of interest, is in default and was in default when this action was commenced."

The bonds in question were bonds of said issue. A verified declaration of its utter inability to pay these bonds as they matured, either out of its own assets or out of borrowings, was the very basis upon which the carrier invoked the provisions of §77 and placed itself thereunder. Furthermore, while that petition was filed June 7, 1933, the instant case was not commenced until June 13, 1934. The bonds in question matured according to their terms on April 1, 1934, and have ever since remained in default. Under such facts which are within the permissive assumptions of Question 2, we contend that a court of equity, dealing with an equitable right strongly favored, should treat the bonds as matured in so far, if at all, as that might be deemed necessary for the protection or exercise of the right:

a. The declared inability to pay, which brought the carrier under §77, should be regarded as in the nature of an anticipatory breach, sufficiently maturing the bonds for all questions of mutual rights arising under §77.

b. The actual maturity and default prior to suit and trial permitted and required the court to deal with the situation then presented.

(a) *The bonds should be treated as matured as of the date of the filing of the petition.*

A positive declaration of inability to perform constitutes an anticipatory repudiation of a contract amounting to a total breach. *Restatement of Law of Contracts,* §318; *Matteson vs. U. S. & Canada Land Co.,* 103 Minn. 407.

And likewise, a placing of one's self in a position wherein he cannot perform constitutes such a breach. *Roehm vs. Horst,* 178 U. S. 1; 2 *Remington on Bankruptcy* (3rd Ed.), §812.

When the carrier placed itself under §77, it placed itself in a position disabling itself, of its own volition at least, from paying the bonds as they matured according to their terms. And again, in *Central Trust Co. vs. Chicago Auditorium Ass'n,* 240 U. S. 581, this court said that bankruptcy

> "proceedings, whether voluntary or involuntary, resulting in an adjudication of bankruptcy, are the equivalent of an anticipatory breach of an executory agreement."

We believe that the filing of the petition itself constituted an anticipatory breach. Whether or not every technical concept of anticipatory breach pre-requisite to a suit at law existed, it seems to us clear that these facts would constitute a sufficient basis for equity to treat them as a sufficient breach to mature the debt for equitable purposes. It is hardly thinkable that a debtor can invoke his own declared inability to pay a given debt to secure the protective benefit of a court of equity and still insist that the debt's formal non-maturity will preclude the equity court from treating the debt as thus matured if necessary to protect a creditor's equitable right.

(b) *Their actual maturity and default at the time of suit and trial below would require recognition of the set-off right.*

Question 2 does not embrace a statement of these facts. Nevertheless they are within the assumptions permissible thereunder. They do appear in the record below and in the findings and opinion of the trial court. If, without them, this court should deem a negative answer indicated as to that question, we still submit that a qualified answer would be required which would sustain the set-off right upon such an hypothesis.

The Bankruptcy Court itself is a court of equity. The court below acted as a court of equity. It was dealing with a right originating in equity and favorably regarded. The power and duty of an equity court to do equity is not limited to the precise situation obtaining when a suit is commenced; it may deal with the situation as presented at the time of trial. 10 *R. C. L.*, "Equity," §344, p. 559; 21 *C. J.* 663 (§846); *Randel vs. Brown*, 2 How. (U. S.) 406; *Colby vs. Street*, 168 Minn. 57; *Pond vs. Harwood*, 139 N. Y. 111; *Huffey vs. Lynch*, 143 N. Y. 241; *Bauer vs. Internat'l, etc., Co.*, 201 Mass. 197; *Breckenridge vs. Carey*, 195 App. Div. 156.

Indeed, a court of equity will go so far as to reinstate a set-off or similar right otherwise lost by ignorance or inadvertence. *Union Nat'l Bank vs. McKey*, 102 Fed. 662 (7 C. C. A.), as to set-off right. Semble: *In re Swift*, 111 Fed. 503 (Dist. Mass.); *Standard Oil Co. vs. Hawkins*, 74 Fed. 395 (7 C. C. A.).

Here, the existence of the deposit account and the bank's ownership of the bonds mutually concurred at the time of the filing of the petition. Under the decision in *North Chi-*

cago Rolling Mill Co. vs. St. Louis Ore & Steel Co., 152 U. S. 596, and the principles there applied *(ante,* Part I), the set-off right was thus in existence when the petition was filed. Even if it were held herein that the filing of the petition in no way accelerated the maturity of the bonds, the permissive hypothesis under Question 2 of maturity and default prior to both the commencement and trial of the trustees' suit would require any equity court, dealing with such an equitable right, to act with regard to the situation thus presented. With the right to exercise set-off then fully matured, that right must be sustained.

Question 2 asks whether the right can be exercised by the bank "upon" the filing of the petition. It may be suggested that the foregoing discussion as to subsequent judicial recognition of the right upon its assertion in the trustees' suit is not within the range of the question. It seems to us that "upon" does not mean "concurrently with." Of necessity, it must mean "after and by reason of," and the question must involve the right of a court to recognize and give effect to the right so asserted.

Certain contentions of appellants.

It is dogmatically asserted that the equities are against the bank and in favor of the trustees (App. Br., p. 24), and hence there should be no relaxing of rules in dealing with the set-off. Under the principles heretofore discussed, no relaxing of rules is involved in the decision below nor in an affirmative answer to Questions 1 and 2. In any event, the equities were as the court below declared. Equity clearly demands preservation rather than confiscation of a substantive right. The maxim that "equality is equity" does not contemplate reducing secured creditors to the ranks of the

unsecured; and it would seem implicit therein that the set-off lien cannot be destroyed when other liens are concededly preserved.

It is asserted that there is no reported case in which a set-off right has been asserted in an equity receivership of a carrier (App. Br., p. 30). Without determining the accuracy of the statement we observe that the right was recognized and enforced in an equity receivership, in *Central Appalachian Co. vs. Buchanan,* 90 Fed. 454 (6 C. C. A.). And we might answer in like tenor, that there is no reported case in which the right of set-off has been denied, in an equity receivership of a carrier. The statistics cited do not establish that such rights have not been asserted and allowed as a matter of course.

It is asserted that a holding that the filing of a petition under §77 accelerates all maturities would prevent successful reorganization (App. Br., pp. 28-30). Subdivisions (a) and (e) of §77 sufficiently answer this suggestion.

We have assumed, as have appellants, that Question 2 is not intended to involve any issue as to mutuality. That issue was separately argued and decided below. Lest there be any doubt about its possible involvement in Question 2 we cite, without discussion, the decisions upholding the view that the sole requisite of mutuality exists when *A* owes *B* and *B* owes *A*, though the debts arise out of disconnected transactions. *Libby vs. Hopkins,* 104 U. S. 303; *Scott vs. Armstrong,* 146 U. S. 499; *Chicago Rolling Mill Co. vs. St. Louis, etc., Co.,* 152 U. S. 596; *Bank vs. Malone,* 76 Fed. (2d) 251 (8 C. C. A.); *Bank vs. Bridewell,* 74 Fed. (2d) 331 (8 C. C. A.). See opinion below, 11 Fed. Suppl. at 936.

We submit that Question 2 should be answered in the affirmative.

IV.

Question 3.

A. This Question as to Whether the Right Should Be Recognized and Established in a Plenary Action by the Trustees in Another District Should Be Answered in the Affirmative.

Question 3, in one sense, seems to assume the jurisdiction of the Minnesota District Court to entertain the suit by the trustees upon the debt represented by the deposit account. If such jurisdiction is presupposed, it would necessarily carry with it the jurisdiction to determine all controversies with respect thereto, including the set-off right. A negative answer to the question would therefore seem necessarily to deny one of the assumptions implicit in the question. This will be later discussed herein. We shall first discuss the question as if no such assumption was involved.

1. The Applicable Statutes and Decisions Require an Affirmative Answer to a Like Question Concerning a Like Action by Trustees Appointed Under the General Provisions of the Bankruptcy Act.

Before attempting to determine what new concepts as to jurisdiction are provided or implicit in §77, it seems important to note carefully the extent of, and limitations upon the jurisdiction of the bankruptcy court under the general provisions of the Bankruptcy Act.

(a) *Jurisdiction under general provisions is administrative, exercisable by summary proceedings, and extended and confined to the debtor and his property within the actual or constructive possession of the court.*

The jurisdiction specially conferred upon bankruptcy courts is administrative. Sections 2, 23a, of Bankruptcy Act (11 U. S. C. A., §§11, 46); *U. S. Fid. & Guaranty Co. vs. Bray,* 225 U. S. 205, 217-8; *Babbitt vs. Dutcher,* 216 U. S. 102, 109.

The jurisdiction of the bankruptcy courts is exercisable only by summary proceedings. *U. S. Fid. & Guaranty Co. vs. Bray,* 225 U. S. 205, *supra;* see also authorities next hereinafter cited.

The basis of such jurisdiction is the actual or constructive possession of the debtor's property. *Isaacs vs. Hobbs,* 282 U. S. 734, 737; *Ex parte Baldwin,* 291 U. S. 610, 615; *Gross vs. Irving Trust Co.,* 289 U. S. 342, 344; *Board of Trade vs. Johnson,* 264 U. S. 1, 11; 5 *Remington on Bankruptcy* (3rd Ed.), §2350, p. 410.

Without such possession the bankruptcy court lacks jurisdiction even as to property within its territorial limits. *Harrison vs. Chamberlin,* 271 U. S. 191, 193; *Galbraith vs. Vallely,* 256 U. S. 46, 50; *Jaquith vs. Rowley,* 188 U. S. 620, 625; *In re Uittenbogard,* 295 Fed. 778 (8 C. C. A.).

(b) *In exercising its administrative or summary jurisdiction, it cannot issue process either in rem or in personam beyond its territorial limits; it must resort to ancillary administration.*

This limitation necessarily follows from the context of Section 2 of the Act which confers the power of bankruptcy administration upon the District Courts

"within their respective territorial limits."

Therefore, the bankruptcy court cannot issue valid process outside its territorial limits; and to extend administration to other districts, resort must be had to ancillary receiverships. (Subd. 20 of §2, Bkptcy. Act, 11 U. S. C. A., §11.)

In *Babbitt vs. Dutcher,* 216 U. S. 102, this court said:

"Proceedings ancillary to and in aid of the proceedings in bankruptcy may be necessary in other districts where the principal court cannot exercise jurisdiction."

In *Acme Harvester Co. vs. Beekman,* 222 U. S. 300, it is said:

"The necessary deduction from these cases is to deny to the district courts jurisdiction such as was sought to be asserted in this case by the issuing of an injunction against one not a party to the proceeding, and which undertook to have effect in the distant jurisdiction outside the territorial jurisdiction of the district court."

Cases expressly recognizing and applying the rule that the bankruptcy court cannot issue valid process either *in rem* or *in personam,* outside its jurisdiction, include the following: *Babbitt vs. Dutcher, supra; Acme Harvester Co. vs. Beekman, supra; Noll vs. Hodgson,* 70 Fed. (2d) 19 (4

C. C. A.); *In re Geller*, 216 Fed. 558 (D. C. N. J.); 5 *Remington on Bankruptcy* (3rd Ed.), §2205, p. 297; Cf. *Robertson vs. Railroad Labor Board*, 268 U. S. 619.

When resort has been had to ancillary administration the scope of that jurisdiction is no greater than the jurisdiction of the primary court. 5 *Remington on Bankruptcy* (3rd Ed.), §2213, p. 312; *De Friece vs. Bryant*, 232 Fed. 233 (D. C. Ky.); *West vs. Empire Life Ins. Co.*, 242 Fed. 605 (D. C. Wash.); *In re Mill Iron Constr. Co.*, 56 Fed. (2d) 248 (D. C. N. Y.).

(c) *Bankruptcy court has no jurisdiction over controversies between trustee and third parties as to debts owed or property adversely possessed and claimed by third parties (with exceptions here immaterial); such controversies must be determined in plenary actions by trustees, in other courts.* (Bankruptcy Act, §23.)

As heretofore noted, the administrative jurisdiction exercisable by summary proceedings finds its sole basis in actual or constructive possession of the debtor's property. As to property adversely possessed and claimed by third parties, or debts owed by third parties, that essential basis of such jurisdiction is lacking. It therefore follows that no such jurisdiction obtains as to such controversies; and that they are to be determined only in plenary actions. 5 *Remington on Bankruptcy* (3rd Ed.), §2134, p. 217; §2350, p. 410, and numerous cases there cited; *Harris vs. First Nat'l Bank*, 216 U. S. 382; see authorities, *ante*.

The bankruptcy court itself has no jurisdiction as to plenary actions (with immaterial exceptions hereinafter noted). Jurisdiction as to such actions is expressly vested

in other courts. These conclusions necessarily follow from Section 23 of the Bankruptcy Act (11 U. S. C. A., §46), and the cases so hold.

That section provides as follows:

> "(a) The United States district courts shall have jurisdiction of all controversies at law and in equity, as distinguished from proceedings in bankruptcy, between trustees as such and adverse claimants concerning the property acquired or claimed by the trustees, in the same manner and to the same extent only as though bankruptcy proceedings had not been instituted and such controversies had been between the bankrupts and such adverse claimants.
>
> (b) Suits by the trustee shall only be brought or prosecuted in the courts where the bankrupt whose estate is being administered by such trustee, might have brought or prosecuted them if proceedings in bankruptcy had not been instituted, unless by consent of the proposed defendant, except suits for the recovery of property under section 96, subdivision b, of this title; section 107, subdivision e, of this title; and section 110, subdivision e, of this title."

The exceptions in the concluding portion of subdivision (b), held to create a limited and concurrent plenary jurisdiction in the bankruptcy court concerning actions to avoid preferences and fraudulent transfers, were added by the 1903 and 1910 amendments. These exceptions, not here material, constitute the only instances in which the bankruptcy court itself has plenary jurisdiction. *Bardes vs. Bank,* 178 U. S. 524; *First Nat'l Bank vs. Chicago Title & Trust Co.,* 198 U. S. 280; 5 *Remington on Bankruptcy* (3rd Ed.); §2135, p. 225; §2183, p. 263; §2187, pp. 266-7; §2189, p. 270.

In *Bardes vs. Bank,* 178 U. S. 524, this court said:

> "On the contrary, Congress, by the second clause of §23 of the present Bankrupt Act, appears to this court to have clearly manifested its intention that controversies, not strictly or properly part of the proceedings in bankruptcy, but independent suits brought by the trustee in bankruptcy to assert a title to money or property as assets of the bankruptcy against strangers to those proceedings, should not come within the jurisdiction of the District Courts of the United States, 'unless by consent of the proposed defendant,' of which there is no pretense in this case."

In *First National Bank vs. Chicago Title & Trust Company,* 198 U. S. 280, this court said:

> "The distinction between steps in bankruptcy proceedings proper and controversies arising out of the settlement of the estates of bankrupts is recognized in §§23, 24 and 25 of the present Act. * * * This distinction existed under the prior bankruptcy law, and the then decisions in respect of a proceeding in bankruptcy and an independent suit are applicable. It was settled that the bankruptcy court was without jurisdiction to determine adverse claims to property, not in the possession of the assignee in bankruptcy, by summary proceedings, whether absolute title or only a lien was asserted * * *
>
> "The present Act was plainly framed in recognition of the principle of these cases."

Within this rule, debtors of the bankrupt are adverse claimants against whom proceedings must be had by plenary action: 5 *Remington on Bankruptcy* (3rd Ed.), §2170, p. 251; §2193, p. 276; *In re Roman,* 23 Fed. (2d) 556 (2 C. C.

A.); *In re Howe Mfg. Co.*, 193 Fed. 524 (D. C. Ky.), particularly when the defendant is a bank asserting a right of set-off. *First Nat'l Bank vs. Hopkins*, 199 Fed. 873 (5 C. C. A.); *In re Radley Steel Constr. Co.*, 212 Fed. 462 (D. C. N. Y.); *In re Boston-Cerrillos Mines Corp.*, 206 Fed. 794, 796 (D. C. N. M.).

> (d) *Accordingly, jurisdiction as to plenary actions by trustees against debtors asserting a set-off right is vested not in the bankruptcy court but in the other courts specified in §23, which have jurisdiction therein to recognize the set-off right and to do so though the set-off claim has not been proved in the bankruptcy court.*

This rule has long been established and followed: *Cumberland Glass Mfg. Co. vs. DeWitt*, 237 U. S. 447, 457; *In re Radley Steel Constr. Co.*, 212 Fed. 462 (D. C. N. Y.); *Citizens Bank vs. Lineberger*, 45 Fed. (2d) 522 (4 C. C. A.); *McDaniel Nat'l Bank vs. Bridwell*, 65 Fed. (2d) 428 (8 C. C. A.); *In re Petrich*, 43 Fed. (2d) 435 (D. C. Calif.); *Norfolk, etc., Ry. Co. vs. Graham*, 145 Fed. 809 (4 C. C. A.); *In re Havens*, 182 Fed. 367 (D. C. N. Y.); *Morgan vs. Wordell*, 178 Mass. 350 (Op. by Justice Holmes); *Wasey vs. Whitcomb*, 167 Mich. 58; *Meighan vs. Cohen*, 161 Minn. 302; *Gill vs. Bank*, 195 S. W. 538 (Mo. App.); *Smith vs. Hale*, 56 S. Dak. 12; *Wagner v. Burnham*, 224 Pa. 586; *Steinhardt vs. Bank*, 120 App. Div. 255, 105 N. Y. S. 23; *Moore vs. Joseph*, 40 S. W. (2d) 948 (Tex. Civ. App.); 4 *Remington on Bankruptcy* (4th Ed.), §1473, p. 249; §1460, p. 231.

In the following authorities above cited it is stated that it may be so asserted though not proved in the bankruptcy

court: *Morgan vs. Wordell, In re Havens, Steinhardt vs. Bank, Moore vs. Joseph, Norfolk, etc., Ry. Co. vs. Graham,* and 4 *Remington on Bankruptcy,* §1460, p. 231.

Appellants have erroneously construed *the Cumberland Glass case* (App. Br., pp. 31-5). In the excerpts quoted, the court merely recognized the power of the bankruptcy court to deal with the set-off right "when its action was invoked for that purpose." There is no doubt that a debtor-creditor of the bankrupt may voluntarily submit the claim to that court. The holding of the court was that a defense that former composition proceedings in bankruptcy had involved a right to set-off of the claim now asserted by plaintiff was not a valid defense, because the right of set-off had not been invoked in the bankruptcy proceedings. The court noted with apparent approval, decisions holding that the set-off could be asserted and sustained in a plenary action by the trustee, 236 U. S. 457-8.

In re Radley Construction Co., 212 Fed. 462, it is said:

> "The test of the right to set off such claims, or as the validity of the debts represented thereby, cannot be determined in a summary manner upon motion, and *a claim by the bank that it holds money on deposit for the purpose of application to the payment of another obligation,* the validity of which can only be determined in some suit against the bank, *must be disposed of in an action in a court having plenary jurisdiction,* unless the bank comes into the bankruptcy court to prove some claim involving the amount of these payments." (Italics ours.)

In *Morgan vs. Wordell,* 178 Mass. 350, Justice Holmes, sustaining such right in a plenary action, said:

> "* * * it follows that, although the defendant's claim could not have been proved against the estate, still it is a mutual credit and may be set-off when he is sued."

Under none of these cases was it ever held or intimated that it was essential to such recognition of the set-off right that it should have been "ordered, authorized, approved or consented to" by the bankruptcy court; the contrary is implicit in all these decisions.

Appellants have quoted from *Isaacs vs. Hobbs,* 282 U. S. 734 (App. Br., pp. 36-7). Neither the decision nor opinion therein conflict with any of the rules heretofore set forth. That case, in its essence, merely illustrates the principle of the administrative jurisdiction of the bankruptcy court as to tangible property actually reduced to the possession of the bankruptcy trustee. It was held that in a foreclosure suit in another district, an answer by the trustee asserting his possession and an outstanding order for sale by the bankruptcy court sufficed to prevent the other court from proceeding with the foreclosure. The language in this opinion, and in many others, as to the bankruptcy court's "exclusive jurisdiction over the debtor's property" is necessarily limited to situations wherein the required basis of such jurisdiction exists, namely, actual or constructive possession of the debtor's property. Under the rules heretofore mentioned, *the concept of such "exclusive jurisdiction" has never been extended to controversies involving either property adversely possessed and claimed by third parties or debts owing the bankrupt against which a set-off right is claimed.*

2. WHATEVER ENLARGED JURISDICTION IS DEEMED CONFERRED BY §77, THE PROVISIONS THEREOF SHOULD NOT BE CONSTRUED AS PREVENTING RECOGNITION OF SET-OFF IN A PLENARY ACTION PROPERLY INSTITUTED BY A TRUSTEE IN ANOTHER COURT.

This question should be considered and here answered upon the basis of §77 as originally enacted and in force at the time of the suit and judgment below. The statute as so enacted is set forth as an appendix to appellants' brief, pages 39-56. As so enacted the only express provisions as to jurisdiction were the following:

The clause in subdivision (a) that upon the approval of the petition,

> "the court in which such order approving the petition is entered shall, during the pendency of the proceedings under this section and for the purposes thereof, have exclusive jurisdiction of the debtor and its property wherever located."

Subdivision (n) as follows:

> "In proceedings under this section and consistent with the provisions thereof, the jurisdiction and powers of the court, the duties of the debtor and the rights and liabilities of creditors, and of all persons with respect to the debtor and his property, shall be the same as if a voluntary petition for adjudication had been filed and a decree of adjudication had been entered on the day when the debtor's petition was filed."

By an amendment adopted August 27, 1935, further provisions were added immediately following the above quoted clause in subdivision (a), as follows:

> "* * * and shall have and may exercise in addition to the powers conferred by this section all the powers, not inconsistent with this section, which a Federal court would have had if it had appointed a receiver in equity of the property of the debtor for any purpose. Process of the court shall extend to and be valid when served in any judicial district. The Supreme Court of the United States shall promulgate rules relating to the service of process outside of the district in which the proceeding is pending, and any other rules which it may deem advisable in order to aid district courts and circuit courts of appeal in exercising the jurisdiction herein conferred upon them."

Whether these additions may affect the final answer to Question 3, as literally stated, need not be immediately discussed. They should not produce an adverse answer to Question 3 as applicable to the case at bar because they were not in effect at the time of the suit or judgment below. The judgment below, recognizing the set-off in this case, was entered June 17, 1935 (11 Fed. Suppl. 929). Clearly, Question 3 should be deemed to relate to §77 as it was in force at the time of entry of the judgment below, which is clearly within the contemplation of that question. We shall first consider Question 3 under §77 as originally enacted and in force during the period here material, later discussing whether the 1935 amendments would call for any different conclusion as applied to proceedings subsequent to those amendments.

It seems obvious that §77 contemplates some jurisdiction in the bankruptcy-reorganization court in addition to that possessed under the general provisions of the Bankruptcy Act. The pertinent question is the extent of the additional jurisdiction so contemplated or provided.

(a) *Cogent reasons sustain construction of §77 as extending administrative jurisdiction exercisable by summary proceedings beyond territorial limits of the court, dispensing with the necessity for ancillary administration.*

The only authoritative views as to the enlarged jurisdiction under §77 are those expressed by this Court in the *Continental Bank case.* That decision sustained the power of the bankruptcy-reorganization court to issue orders, effective beyond its territorial limits, temporarily staying foreclosure by pledgees of collateral held by them. Persistence of limitations upon the jurisdiction are implicit in the opinion, as follows:

(a-1) The power was sustained primarily as an exercise of the administrative power existing under §2 of the Bankruptcy Act (294 U. S., at 675, 676, 678) extended beyond the territorial limits by subdivision (a) of §77 *(ibid.,* at 682-3).

(a-2) It was recognized that the power was invoked in a summary proceeding *(ibid.,* at 681, 682) to protect the debtor's property, i. e., its equity in the collateral *(ibid.,* at 681, 683).

(a-3) It was recognized that §77 evidenced "a manifest policy of avoiding ancillary administration as far as possible" *(ibid.,* at 684).

The reasons supporting these conclusions as to intended extension of jurisdiction are found in the opinion and need not here be reviewed. It may suffice to say that the conclusions are in accord with appropriate rules of construction. They evince no radical departure from established policy. They lead to no substantial infringement upon the rights of third parties.

(b) *Cogent reasons preclude construction of §77 as creating plenary jurisdiction to adjudicate controversies with third parties as to debts owed or property adversely and claimed.*

At the outset, it should be noted that the practical reasons for extending the summary jurisdiction beyond territorial limits so as to dispense with ancillary administration do not support any view in favor of creating a plenary jurisdiction not existing under the general provisions of the Bankruptcy Act. Ancillary administration involves cumbersomeness, makes for delay and involves much greater expense, all avoided by dispensing with such administration.

But the investing of the court with plenary jurisdiction to adjudicate controversies with third parties would not accomplish like ends. It would tend to produce some contrary results. Carriers may have hundreds, if not thousands, of controversies with third parties, not within the scope of the administrative or summary jurisdiction of a bankruptcy court, including claims for demurrage, undercharges and others incident to the operation of its business. Such claims may exist against shippers or consignees throughout the country. It is hardly conceivable that Congress intended the unfairness which would be incident to a requirement that such parties should come to the bankruptcy-reorganization court to assert and litigate their defenses to such claims. And any such view would tend to swamp such courts with a multitude of separate actions, resulting in congested calendars and substantial delay in dealing with the more vital problems of actual administration and reorganization. Practical considerations, therefore, suggest no purpose or reason for construing §77 as departing from the long-established policy of bankruptcy legislation which has con-

sistently withheld from the bankruptcy court jurisdiction as to plenary actions involving controversies with third parties. Such considerations, as well as established rules of construction, indicate that no such new concept of jurisdiction was intended.

Authorities previously cited and discussed herein establish that no such jurisdiction exists under the general provisions of the act. Section 77 does not expressly provide for such new jurisdiction. No construction affecting a radical departure from long recognized principles of legislative policy should be indulged. *Robertson vs. Railroad Board,* 268 U. S. 619; *Panama R. R. Co. vs. Johnson,* 264 U. S. 375; *Daniel vs. Guaranty Trust Co.,* 285 U. S. 154, 162.

Furthermore, subdivision (n) of §77 expressly provides, *inter alia*, that

> "in proceedings under this section and consistent with the provisions thereof, *the jurisdiction and powers of the court * * * shall be the same*" (Italics ours.)

as under the general provisions of the Bankruptcy Act. In the *Continental Bank* case, this court, while recognizing that to the extent that subdivision (a) of §77 invested the court with exclusive jurisdiction as to the debtor and its property wherever located, the summary jurisdiction was extended beyond the territorial limits, clearly held that the application of Clause 15 of Section 2 of the Bankruptcy Act persisted under §77. By the same token, and particularly under the express provision in subdivision (n), "the jurisdiction and powers of the court" are still affected by Section 23 of the Bankruptcy Act denying to the bankruptcy court (with immaterial exceptions), and vesting in other courts, plenary jurisdiction in controversies between trustees and third parties.

The reference in subdivision (a) of §77 to jurisdiction of

the debtor and "its property wherever located" serves only to extend the summary jurisdiction territorially. It does not create a plenary jurisdiction not theretofore existing. We have noted that under the general provisions vesting exclusive jurisdiction over the debtor and his property within the territorial limits, the term "his property" as applied to assets subject to a lien, means only the debtor's equity; and that such jurisdiction does not extend to a determination in plenary actions of controverted issues with a lienor or with a third party asserting a set-off right. In the *Continental Bank* case, this Court attributed to the term "its property" as found in subdivision (a) the same limited meaning. Speaking of the collateral, the Court said:

> "That the equity which the debtor retained was a property interest was not and could not be disputed."

And again:

> "The equity in the collateral remaining in the railroad company is property; and over this, whenever located, the federal district court is given exclusive jurisdiction by the precise language of §77" (i. e., subd. a).

The power to enjoin a sale was sustained as a necessary incident of the right to protect that equity.

In re Prudence Bonds Corporation, 75 Fed. (2d) 262 (2 C. C. A.), involved the validity of an order of a bankruptcy court under §77B restraining an accounting suit in state court by a holder of the debtor's bonds, secured by pledged collateral. After noting provisions in §77B, similar to those just cited in subdivisions (a) and (n) of §77, the court said:

> "It is clear both from the language used in these subdivisions, and from the consequences of a contrary ruling, that Congress did not intend the bankruptcy court in proceedings under section 77B to take over all litigation between the debtor and third persons."

In the Matter of United Sportwear Company, Inc., 28 Am. Bankruptcy Reports (N. S.) 451 (D. C. Mass., May 20, 1935), a debtor under §77B petitioned for a summary order directing payment by a bank of the amount of a deposit account. The bank, holding the debtor's note for a like amount, had set off the same against the deposit account. The court said:

> "The bank has objected to the jurisdiction of the court to act summarily and claims it is not subject to a plenary suit in this court without its consent. The objection to jurisdiction and to venue are well and seasonably taken and debtor's petition must be denied."

Like conclusions under like provisions of §77 seem clearly required. There is no basis for any view that §77 newly creates in the bankruptcy-reorganization court any plenary jurisdiction, exclusive or concurrent, to adjudicate controversies between trustees and third parties as to property adversely possessed and claimed or as to choses in action against which a set-off right is asserted.

Such jurisdiction has never before been granted to a bankruptcy court. No provision of §77 purports to create it. No basis for implying it exists. Practical considerations, established rules of construction and the express provisions of subdivision (n) compel the conclusion that jurisdiction as to such controversies and actions remains as before. Accordingly, the Minnesota District Court had jurisdiction to entertain the trustees' suit upon the deposit account and to recognize and establish therein the set-off right.

(c) *Even if §77 were properly to be construed as vesting such plenary jurisdiction in the bankruptcy court, the latter may consent to exercise of jurisdiction by other courts; and here, such consent should be assumed from the trustees invoking the jurisdiction of the Minnesota District Court.*

Even as to matters concerning which the bankruptcy court is invested with exclusive jurisdiction, that court may consent to litigation by the trustee in other courts. *Ex parte Baldwin,* 291 U. S. 608, 619; Cf. *In re Missouri, etc., Service Co.,* 11 Fed. Suppl. 434 (D. C. Mo.); *In re Sentinel Oil Co.,* 12 Fed. Suppl. 294 (D. C. Calif.).

Question 3 as certified indicates that the trustees appointed by the bankruptcy court in Illinois voluntarily instituted this action in the District Court of Minnesota. It would seem that it should be assumed that in so doing they were acting properly and not unlawfully. This would necessitate the assumption of consent of the court appointing them if that should be deemed a requisite of their right to institute the action.

Certainly, the trustees should not here be heard to deny the very jurisdiction they have voluntarily invoked. It is true that consent cannot create a jurisdiction otherwise lacking. But clearly the trustees cannot here insist that the Minnesota District Court has jurisdiction to award them a judgment for recovery upon the deposit account but is without jurisdiction to allow the set-off right. If any jurisdiction exists in the Minnesota court in the action assumed in the question, it includes the jurisdiction to determine the whole controversy.

The 1935 amendments to §77.

We have heretofore noted that the judgment of the District Court below was rendered June 17, 1935, prior to the amendments to §77 adopted August 27, 1935. Question 3 in its relation back to Questions 1 and 2 deals with §77—not with §77 as amended. It should be so construed because of the fact above noted. If this Court should deem the question to relate to §77 as amended and should reach a negative answer based upon such amendments, the answer should clearly so indicate. The Circuit Court of Appeals must base its ultimate decision upon the effect of §77 without the amendments, and care should be had to avoid confusion or misunderstanding which might result from a negative answer based upon the amendments.

In so far as Question 3 is concerned, we further submit that the amendments should not produce a negative answer. The clause conferring the powers of a federal court in an equity receivership add nothing upon this issue. A federal equity court had no jurisdiction to determine set-off in a summary proceeding; the right is determinable in a plenary action by a receiver. *McDaniel vs. Bridwell*, 65 Fed. (2d) 428, *ante*. The provision that process may extend to other districts is not an investiture of additional jurisdiction. It is clearly in aid only of the summary jurisdiction otherwise granted or existing. The same must be true as to the provisions for promulgation of rules by this Court as to such service.

We submit that §77 has not provided, expressly or by implication, for departure from the long established policy and rule that plenary jurisdiction over controversies between trustees and third parties, relating to property adversely possessed and claimed and to choses in action against which

a set-off right is claimed, is vested in those courts which would have jurisdiction in like actions between the bankrupt and the third party. That being so, it is wholly immaterial that the set-off right, long held cognizable by such other courts, has not been "ordered, authorized, approved or consented to" by the bankruptcy court. In passing it may be noted that Question 3 does not assume any order of the bankruptcy court forbidding the institution of such a suit by the trustee in another court nor any order of the bankruptcy court purporting to forbid, or stay, the exercise of the set-off right. In any event, under the authorities heretofore discussed, that court has no jurisdiction to forbid or stay the exercise of that right. Such an edict, if effective in a suit by the trustee, would totally destroy the right. Jurisdiction to determine the right (except by consent) does not rest with the bankruptcy court. It never has; and under §77 it remains in other courts as above noted.

B. Any Negative Answer to Question 3 Can Only Be Based Upon Total Absence of Jurisdiction of the Minnesota Court, Requiring Dismissal of the Trustees' Suit Below Without Recovery and With Preservation of the Set-Off Right for Adjudication by the Illinois Court.

We have submitted that Question 3 should be answered in the affirmative. However, if this Court should reach a contrary conclusion, the situation presented would seem to make it appropriate that the consequences of a negative answer be clearly indicated.

Any negative answer must, of necessity, be based upon a view that §77 vests plenary jurisdiction exclusively in the

bankruptcy court. Of necessity, that would mean that the District Court of Minnesota had no jurisdiction to entertain the trustees' suit. That, in turn, would mean that all proceedings below are a nullity. Any stated incapacity of the Minnesota Court to recognize and establish the set-off right (existing under the assumed affirmative answers to Questions 1 and 2) would follow, if at all, from the total lack of jurisdiction of that court to entertain the plenary action. If that conclusion be reached, we submit that the attainment of a proper result below would require an answer indicating the basis therefor and that the required result would be a dismissal of the trustees' suit below. Allowance of recovery by the trustees below, free from the set-off, would destroy the very right assumed in Question 3 as existing. Only by dismissal of the trustees' present action could that right be preserved for adjudication by the Illinois Court, if it should be concluded herein that it is the sole forum for adjudication or establishment of the set-off right.

CONCLUSION.

We submit that each of the three certified questions should be answered unqualifiedly in the affirmative. We also submit that if any contrary conclusions should be reached concerning Questions 1 and 3 as stated, the answers should be qualified as herein suggested in the discussion of those questions.

March 23, 1936.

Respectfully submitted,

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Counsel for Appellee Below.

FILE COPY

Supreme Court of the United States

OCTOBER TERM, 1935

No. 743

FRANK O. LOWDEN, JAMES E. GORMAN AND JOSEPH B. FLEMING, as Trustees of the Estate of the Chicago, Rock Island & Pacific Railway Company,

vs.

NORTHWESTERN NATIONAL BANK AND TRUST COMPANY OF MINNEAPOLIS, MINNESOTA, Formerly the Northwestern National Bank of Minneapolis, Minnesota.

On Certificate from the United States Circuit Court of Appeals for the Eighth Circuit

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BRIEF OF AMICUS CURIA

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Service of this Brief is hereby accepted and copies acknowledged received, this..... day of April, 1936, by the undersigned.

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BRIEF OF AMICUS CURIA

BRIEF FILED WITH LEAVE OF COURT

This Brief is filed with leave of Court first had, by Garfield E. Breese as amicus curia.

OPINION BELOW

The opinion of the District Court below was filed June 17, 1935. It is reported as **Lowden, et al vs. Northwestern National Bank and Trust Company of Minneapolis,** in 11 Fed. Suppl. 929 (D. C., Minn.). The Circuit Court of Appeals has filed no opinion, reserving decision pending the opinion of this Court upon the questions certified.

JURISDICTION

The United States Circuit Court of Appeals, Eighth Circuit, has certified to this Court, three questions of law involved in this cause, under the provisions of Section 239 of the Judicial Code as amended (28 U. S. C. A. Sec. 346).

QUESTIONS CERTIFIED

The questions certified for answer, in the order certified, are as follows:

> Question 1. Does the right of setoff recognized by Section 68(a) of the Bankruptcy Act apply to reorganization proceedings under Section 77 of that act?
>
> Question 2. If the first question be answered in the affirmative, can a bank which owns the unmatured bonds of a railroad corporation set off a deposit account of the railroad with the bank against the bonds, upon the filing by the railroad of a petition for reorganization under Section 77 of the Bankruptcy Act, alleging that the railroad is unable to meet its debts as they mature?
>
> Question 3. If the first and second questions be answered in the affirmative, may the United States District Court for the District of Minnesota, in the suit by the trustees of the railroad's estate to recover the amount deducted from the account of the railroad by the bank under the claimed right of setoff, recognize and establish as a proper setoff by the bank one which was not made until after the filing of the petition for reorganization and which has never been ordered, authorized, approved, or consented to by the Court in which that petition was filed and approved?

STATUTES INVOLVED

The statutes directly involved are Sec. 77 of the Banktruptcy

Act (as adopted March 3, 1933), U. S. C. A. Sec. 205; and Sec. 68 of the Bankruptcy Act, U. S. C. A. Sec. 108.

Said Section 77 is set forth in full as an Appendix to Appellants' Brief (p. 65).

The material parts of said Section 68 are as follows:

"(a) In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid.

"(b) A setoff or counterclaim shall not be allowed in favor of any debtor of the bankrupt which (1) is not provable against the estate * * *"

Said Section 77 provides:

"(n) In proceedings under this section and consistent with the provisions thereof, the jurisdiction and powers of the Court, the duties of the debtor and the rights and liabilities of creditors, and of all persons with respect to the debtor and his property, shall be the same as if a voluntary petition for adjudication had been filed and a decree of adjudication had been entered on the day when the debtor's petition was filed."

"(g) Upon such approval by the commission, and after hearing such objections as may be made to the approved plan, the Judge shall confirm the plan if satisfied that (1) the approved plan complies with the provisions of subdivision (b) of this section, is equitable and does not discriminate unfairly in favor of any class of creditors or stockholders; * * * (6) the plan provides with respect to any class of creditors the acceptance of which is requisite to the confirmation of the plan, and who would not become bound by the plan under the provisions of subdivision (h) of this section, adequate protection for the realization by them of the value of their securities, liens, and claims, either (a) by the sale of such property subject to their liens, if any, or (b) by the sale free of such liens at

not less than a fair upset price, and the transfer of such liens to the proceeds of such sale, or (c) by appraisal and payment in cash of either the value of such liens and claims or, at the objecting creditors' election, the value of the securities allotted to such liens and claims under the plan. * * *"

STATEMENT OF CASE

The statement of the case as certified by the United States Circuit Court of Appeals is set out on pages 2-4 of Appellants' Brief.

SUMMARY OF ARGUMENT

I

Question No. 1. Does the right of setoff recognized by Section 68(a) of the Bankruptcy Act apply to reorganization proceedings under Section 77 of that act?

A. Setoff is a substantive right, not merely a procedural remedy, based upon a possessory lien.

B. The reorganization statute, Sec. 77(n), by its terms provides that consistent therewith, the rights and liabilities of creditors shall be the same as in the case of voluntary bankruptcy, which is "one debt shall be setoff against the other, and the balance only shall be allowed or paid." (Sec. 68(a).

C. If right of setoff is denied, the possessory lien is destroyed, since the fund would be checked out and the creditor would take only with general creditors.

D. Enjoining foreclosure of collateral pending efforts to reorganize the debtor, does not destroy the collateral or preferred position of the creditor. But denial of right of setoff, destroys it and the possessory lien on which it is based.

II

Question No. 2. If the first question be answered in the affirmative, can a bank which owns unmatured bonds of a railroad corporation set off a deposit account of the railroad with the bank against the bonds, upon the filing by the railroad of a petition for reorganization under Section 77 of the Bankruptcy Act, alleging that the railroad is unable to meet its debts as they mature?

A. Maturity of the bonds is not essential to exercise of right of setoff, because unmatured debts are provable and therefore may be set off under Sec. 68.

B. Neither is insolvency of the railway essential to the setoff:

1. Because insolvency is not a prerequisite to adjudication of bankruptcy under Sec. 68.
2. Because Sec. 68 gives right of setoff without reference to insolvency of debtor.

C. Even if insolvency of the railway were to be held essential to exercise of right of setoff, the fact of insolvency must be regarded as proven:

1. Because inability to meet its debts as they mature and availing itself of the benefits of Sec. 77 are sufficient proof thereof.
2. Because to hold that insolvency of the railway company can be proven only through the marshalling of assets against liabilities, would be to hold that all ordinary creditors, those not having millions at stake, would be helpless because a court of equity had required proof beyond the reach and power of any such creditor.

D. The bank owning railway bonds owing by the railway company and being indebted to the railway company, on checking account, there exists mutual debts and credits, contemplated by Sec. 68 (a).

III

Question No. 3. If the first and second questions be answered in the affirmative, may the United States District Court for the District of Minnesota, in the suit by the trustees of the railroad's estate to recover the amount deducted from the account of the railroad by that bank under the claimed right of setoff, recognize and establish as a proper setoff by the bank one which was not made until after the filing of the petition for reorganization and which has never been ordered, authorized, approved, or consented to by the court in which that petition was filed and approved?

A. At the time the railway company petition was filed and approved, under Sec. 77, the bank was a debtor of the railway company on the railway's checking account, and a creditor of the railway by virtue of holding railway bonds. No possession, actual or constructive, of property was involved—merely a creditor and debtor relationship—therefore "one debt shall be set off against the other and the balance only shall be allowed or paid." (Sec. 68(a).

B. The good faith assertion of lien on property of the bankrupt, where the property and claimant are outside the jurisdiction of the Bankruptcy Court, requires the trustee in bankruptcy, who would contest that lien, to seek relief in the court of the jurisdiction of the property or claimant.

C. Were Sec. 77 to be given the necessarily strained construction, to authorize such plenary jurisdiction in the Bankruptcy Court, still the latter can consent to such jurisdiction in other competent courts. The bringing of this action by the trustees in the United States District Court of Minnesota, presumes such consent.

Were the above proposition not true, then we would have the anomalous situation where the trustees in

bankruptcy could invoke the jurisdiction of the United States District Court in Minnesota and be accorded relief therein and at the same time successfully resist the right of the adverse party to be heard in opposition to the trustees' claim.

ARGUMENT

I

Question No. 1 is as follows: Does the right of setoff recognized by Section 68(a) of the Bankruptcy Act apply to reorganization proceedings under Section 77 of that act?

A. The right of setoff is a substantive right, not merely a procedural remedy.

In **First National Bank vs. Malone,** 76 Fed. (2d) 251 (8 C. C. A.), the Court, discussing the equitable origin and nature of setoff and its accomplishment of justice, said:

> "While the doctrine was originally 'a mere procedural convenience, it has now become really a requirement of substantive justice.'"

In **Wisdom vs. Guess Dry Cleaning Co.,** 5 Fed. Suppl. 762 (Dist. Mass.), after an extensive discussion of the setoff right, the Court said:

> "We have seen that the better modern view regards setoff as a substantive right."

The right has been characterized as in the nature of a lien, by this court and others. **Central National Bank vs. Connecticut, etc., Co.,** 104 U. S. 54; **Goodwin vs. Barre Savings, etc., Co.,** 91 Vt. 286; **Andrew vs. American Savings Bank,** 218 Iowa 489; see also **Champlin Refining Co vs. Gasoline Products Co.,** 29

Fed. (2d) 331, 338 (1 C. C. A.); **In re W. & A. Bacon Co.**, 261 Fed. 109, 111 (Dist. Mass.).

In **Studley vs. Roylston National Bank,** 229 U. S. 523, this court, in sustaining the right in bankruptcy proceedings, said:

> "That section did not create the right of setoff, but recognized its existence, and provided a method by which it could be enforced even after bankruptcy. What the old books called a right of stoppage—what business men call setoff—is a right given or recognized by the commercial law of each of the states, and is protected by the bankruptcy act if the petition is filed before the parties have themselves given checks, charged notes, made book entries, or stated an account whereby the smaller obligation is applied on the larger.
>
> "**The banker's lien on deposits,** the right of retention and setoff of mutual debts, are frequently spoken of as though they were synonymous, while in strictness, a setoff is a counterclaim which the defendant may interpose by way of cross-action against the plaintiff. But, broadly speakin, **it represents the right which one party has against another to use his claim in full or partial satisfaction of what he owes to the other.** That right is constantly exercised by business men in making book entries whereby one mutual debt is applied against another." (Boldface ours).

The setoff right is one which the courts zealously guard.

In **Central Appalachian Co. vs. Buchanan,** 90 Fed. 454 (6 C. C. A., before Taft and Lurton, Circuit Judges, and Clark, District Judge), in an extensive discussion of the setoff right, the Court said:

> "So, courts of equity of the United States have been peculiarly alert to prevent the defeat of an equitable right of setoff by the interposition of assignments, receiverships or

statutory liquidations, and to extend the right whenever there appeared any substantial equity in favor of the claim."

B. Subdivision "n" of Section 77 (the reorganization statute) by its terms provides that consistent therewith, the rights and liabilities of creditors shall be the same as in the case of voluntary bankruptcy, which is "one debt shall be set off against the other, and the balance only shall be allowed or paid." (Sec. 68(a).

To answer Question 1 in the negative would be to say that the above provision of the statute is meaningless—an idle gesture. To hold that the right of setoff does not apply under Section 77 would be to read inconsistent language into the statute or to give it a strained construction wholly at variance with its plain terms.

C. Denial of the right of setoff utterly destroys the right. The distinction between enjoining the temporary foreclosure of a collateral lien such as was done in the case of Continental Illinois National Bank and Trust Company vs. C. R. I. & P. Ry. Co. (decision by U. S. Supreme Court April 1, 1935, 79 L. Ed. 642) on the one hand, and the denial of right of setoff on the other, should be clearly noted, because enjoining the foreclosure of collateral does not destroy, but merely suspends the right, while denial of the right of setoff utterly destroys the right because the subject of the setoff (the checking account in the bank) will be checked out and nothing will be left to set off.

As applied to the case at hand, denial of the right of setoff would deprive the bank, for all time, of the setoff right by destroying it, and would directly contravene the provisions of said Section 77, subdivisions (d) to (g).

Sub-paragraph 6 of subdivision (g) requires the preservation of the setoff right in different language:

> "adequate protection for the realization by them (creditors) of the value of their securities, liens and claims."

The Continental Illinois National Bank & Trust Company case, supra, makes positive that statement (referring to the enjoining of foreclosure of collateral) in the following language:

> "The injunction does not infringe Sec. 67(d) U. S. C. A., Title 11, Sec. 107(d). The substance of that provision is that bona fide liens shall not be affected by anything contained in the Bankruptcy Act. The injunction here in no way impairs the lien, or disturbs the preferred rank of the pledgees. **It does no more than suspend the enforcement of the lien."** (Boldface ours).

To argue then, that the right of setoff is not available under Sec. 77, is not only to misinterpret plain provisions of subdivision "n", but also to ignore the holding of the Supreme Court of the United States in the Continental Illinois Bank case.

II

Question No. 2 is as follows: If the first question be answered in the affirmative, can a bank which owns the unmatured bonds of a railroad corporation set off a deposit account of the railroad with the bank against the bonds, upon the filing by the railroad of a petition for reorganization under Section 77 of the Bankruptcy Act, alleging that the railroad is unable to meet its debts as they mature?

A. The maturity of the bonds in question is not essential to the exercise of right of setoff, because unmatured debts are provable in bankruptcy and therefore subject to setoff under Section 68 of the Bankruptcy Act.

Section 63(a)(1) of the Bankruptcy Act provides:

> "Debts provable against: (a) Debts of the bankrupt may be proved and allowed against his estate which are

(1) a fixed liability as evidenced by a judgment or an instrument in writing, absolutely owing at the time of the filing of the petition against him, whether then payable or not."

Not only is maturity not essential, but the debits and credits may have arisen out of wholly disconnected transactions.

In the case of **North Chicago Rolling Mill Co. vs. St. Louis Ore & Steel Co.**, 152 U. S. 596; 38 L. Ed. 565, the Court said:

"Cross demands and counterclaims, whether arising out of the same or wholly disconnected transactions, and whether liquidated or unliquidated, may be enforced by way of setoff whenever the circumstances are such as to warrant the interference of equity to prevent wrong and injustice."

B. Insolvency of the Railway Company is not essential to exercise the right of setoff.

Insolvency is not a prerequisite to adjudication of bankruptcy under Section 68.

George M. West Co. vs. Lea Brothers & Co., 174 U. S. 590; **In re Cohn**, 227 Fed. 843 (certiorari denied); **Blumenthal vs. Strat**, 241 U. S. 662; **In re C. R. I. & P. Ry. Co., 72 Fed.** (2d) 443; 450; **In re Hargadine, etc., Co.**, 239 Fed. 155 (Dist. Mo.); **In re Dressler Producing Corp.**, 262 Fed. 257 (2 C. C. A.); **1 Remington on Bankruptcy** (4th Ed.), Sec. 48; 11 U. S. C. A., Sec. 21, note 2-p. 177, note 82-p. 213, note 132-p. 235, and numerous cases cited.

Therefore under the Bankruptcy Act we have the situation where insolvency of the bankrupt is not essential, and yet where, under Section 68, the right of setoff is allowed.

C. Even were it to be conceded (which of course it is not) that insolvency of the Railway were essential to exercise of the right of setoff by the bank, the fact of insolvency must be regarded as proven:

1. Because the admission that the Railway was unable to meet its debts as they mature, and as a consequence availed itself of the provisions of Section 77, establishes the fact of insolvency for all practical purposes.
2. Because to hold otherwise would be to hold that insolvency of the Railway could be proven only through the marshaling of assets against liabilities.

The requirement of such proof would place an utterly insolvent Railway in an enviable and unjustifiable position as against practically all creditors, because such proof would be impossible at the hands of such creditors. To establish such a rule as the basis for proof of insolvency, the court of equity would be merely saying to all creditors except multi-millionaires, that even though the Railway is insolvent, it will require proofs thereof that are to all practical purposes impossible.

We submit that a court of equity will not place creditors in that position.

D. The requirement of mutuality of debits and credits, under Section 68, is met where the Railway Company is indebted to the Bank on its bonds and the Bank is indebted to the Railway on checking account carried by the Railway Company in the Bank.

Again we quote from the case of **North Chicago Rolling Mill Company vs. St. Louis Ore & Steel Co.**, 152 U. S. 596; 38 L. Ed. 565:

"Cross demands and counterclaims, whether arising out of the same or wholly disconnected transactions, and whether liquidated or unliquidated, may be enforced by

way of setoff whenever the circumstances are such as to warrant the interference of equity to prevent wrong and injustice."

In the case of **Scott vs. Armstrong,** 146 U. S. 499; 36 L. Ed. 1059, the Court says:

"Courts of equity frequently deviate from the strict rule of mutuality when the justice of the particular case requires it."

In the case of **Bank of Commerce & Trust Company vs. Hood,** 65 Fed. (2d) 281 (5th C. C. A.) the Court dealt with a situation where the bank owned bonds which it proposed to offset against the bank balance in the general deposit account of the depositor.

The Court said:

"But it should not have required the turning into the hands of its receiver of $19,466.56 of money without reference to the offsets claimed by the bank against the mortgagor. The general deposit was but a debt, and the receiver standing in the shoes of Willets Wood Products Company, was entitled only to an account and the payment of the balance, if any."

In the late case of **First National Bank of Indianola vs. Malone, et al,** 76 Fed. (2d) 251 (C. C. A. 8th), the Court says:

"Where no superior equities intervene, the setoff of a deposit against the debt upon an unmatured note is allowed upon the theory that in good conscience one ought not pay his debt to his creditor if he cannot ultimately compel his creditor to pay the debt due him. * * * The fact that the claim of the bank on its note was not due at the moment of suspension of the bank, cannot have the effect of

destroying the mutuality essential to the right of setoff."

In the case of **McDaniel National Bank vs. Bridwell,** 74 Fed. (2d) 331 (C. C. A. 8th), the Court referred to subdivision (a) of Section 68 of the Bankruptcy Act, and stated:

> "From the wording of this sub-section it is evident that, before the creditor may enjoy the use of a setoff principle against the bankrupt's estate, two essential elements must be established: (1) Two debts must exist, one to the creditor and one to the bankrupt's estate; (2) These debts must be mutual, that is, the creditor's debt must be owing to the estate of the bankrupt and the estate's debt must be owed to this creditor. When these conditions are fulfilled, the statute applies with full force and may be taken advantage of."

III

Question No. 3 is as follows: If the first and second questions be answered in the affirmative, may the United States District Court for the District of Minnesota, in the suit by the trustees of the railroad's estate to recover the amount deducted from the account of the railroad by the bank under the claimed right of setoff, recognize and establish as a proper setoff by the bank one which was not made until after the filing of the petition for reorganization and which has never been ordered, authorized, approved, or consented to by the court in which that petition was filed and approved."

A. At the time the Railway Company's petition was filed and approved by the Bankruptcy Court, the bank was a debtor of the Railway Company by virtue of the Railway Company's checking account in the Bank, and the Bank on the other hand was a creditor of the Rail-

way Company by virtue of its ownership of railway bonds. No possession, actual or constructive, of the property was involved—merely a creditor and debtor relationship; therefore, "one debt shall be setoff against the other, and the balance only shall be allowed or paid." (Sec. 66a).

The argument that the jurisdiction of the Bankruptcy Court where the petition was filed, was so exclusive that setoff of mutual credits against mutual debts would not be permissible (and that is what a negative answer to Question No. 3 would mean) would be to carry logic beyond the realm of reason, and reason beyond the realm of logic.

In the first place the jurisdiction of that court is necessarily administrative.

Batbbitt vs. Dutcher, 216 U. S. 102, 109;

U. S. Fidelity & Guaranty Co., vs. Bray, 225 U. S. 205, 217;

The basis of such jurisdiction is actual or constructive possession of the debtor's property. **Isaacs vs. Hobbs,** 282 U. S. 734, 737; **Ex parte Baldwin,** 291 U. S. 610, 615; **Gross vs. Irving Trust Co.,** 289 U. S. 342, 344; **Board of Trade vs. Johnson,** 264 U. S. 1, 11; **Remington on Bankruptcy** (3rd Ed.), Sec. 2350, p. 410.

Without such possession the bankruptcy court lacks jurisdiction even as to property within its territorial limits. **Harrison vs. Chamberlin,** 271 U. S. 191, 193; **Galbraith vs. Vallely,** 256 U. S. 46, 50; **Jaquith vs. Rowley,** 188 U. S. 620, 625; **In re Uittenbogard,** 295 Fed. 778 (8 C. C. A.)

B. The good faith assertion of a lien on property of the debtor, where the property and claimant are ouside the jurisdiction of the Bankruptcy Court, requires the trustee in bankruptcy, who would contest that lien, to seek relief by plenary action in the court of the jurisdiction

of the property or claimant.

The language of Section 23 of the Bankruptcy Act makes this plain. That section provides as follows:

"(a) The United States District Courts shall have jurisdiction of all controversies at law and in equity, as distinguished from proceedings in bankruptcy, between trustees as such and adverse claimants concerning the property acquired or claimed by the trustees, in the same manner and to the same extent only as though bankruptcy proceedings had not been instituted and such controversies had been between the bankrupts and such adverse claimants.

"(b) Suits by the trustee shall only be brought or prosecuted in the courts where the bankrupt whose estate is being administered by such trustee, might have brought or prosecuted them if proceedings in bankruptcy had not been instituted, unless by consent of the proposed defendant except suits for the recovery of property under Section 96, subdivision "b" of this title; Section 107, subdivision "e" of this title; and Section 110, subdivision "e" of this title."

The point is also determined by the United States Supreme Court in the case of **Bardes vs. Bank,** 178 U. S. 524:

"On the contrary, Congress, by the second clause of Sec. 23 of the present Bankrupt Act, appears to this court to have clearly manifested its intention that controversies, not strictly or properly part of the proceedings in bankruptcy, but independent suits brought by the trustee in bankruptcy to assert a title to money or property as assets of the bankruptcy against strangers to those proceedings, should not come within the jurisdiction of the District Courts of the United States, 'unless by consent of the proposed defendant,' of which there is no pretense in this case."

In First National Bank vs. Chicago Title & Trust Company 198 U. S. 280, this court said:

> "The distinction between steps in bankruptcy proceedings proper and controversies arising out of the settlement of the estates of bankrupts is recognized in Sections 23, 24, and 25 of the present act. * * * This distinction existed under the prior bankruptcy law, and the then decisions in respect of a proceeding in bankruptcy and an independent suit are applicable. It was settled that the bankruptcy court was without jurisdiction to determine adverse claims to property, not in the possession of the assignee in bankruptcy, by summary proceedings, whether absolute title or only a lien was asserted. * * *
>
> "The present act was plainly framed in recognition of the principle of these cases."

This Brief, to avoid repetition, adopts the further argument on this proposition set forth in the Brief of Appellee, pages 56 to 65, both inclusive, it being our opinion that the same fairly fully and irrefutably covers the proposition.

C. Were Section 77 to be given the necessarily strained construction to hold that such plenary jurisdiction, rests in the Bankruptcy Court, still that Court can consent to such jurisdiction in other competent courts. The bringing of this action by the trustees in the United States District Court of Minnesota, presumes such consent. To hold otherwise would be to hold that the trustees acted illegally. This presumption will not be indulged.

D. It would give rise to an anomalous situation were the trustees permitted to invoke the jurisdiction of the United States District Court of Minnesota, and then be heard to deny that jurisdiction.

It should be borne in mind that the action is brought by the trustees for affirmative relief. To answer Question 3 in the negative would be in effect to permit the trustees to invoke the jurisdiction of the Minnesota court and obtain relief therefrom, and at the same time to grant the trustees the right to deny the adverse parties the right to be heard in that court.

The right does not exist in the trustees to receive in that Court and not to give. Jurisdiction in that Court in the first instance precludes denial of its jurisdiction as to the counter features involved.

Were the holding to be that the Minnesota Court is without jurisdiction, then it necessarily follows that the plaintiff's action arising therein and invoking that Court's jurisdiction, should be dismissed. We believe that that jurisdiction was properly invoked by the plaintiffs at the inception of this action, but were it to be held otherwise, we respectfully ask that in the determination of the questions certified, the Court specify fully the status of the parties in relation to said action, including the provision that the plaintiff's action itself must fail in order that the rights of the parties to the action may all be preserved for assertion in the proper forum.

CONCLUSION

We respectfully submit that the three certified questions should each and all be answered in the affirmative.

We respectfully ask that any contrary holding be accompanied by suitable direction and qualifications such that the rights of the defendant by way of setoff shall not be destroyed.

March 27, 1936.

Respectfully submitted,

GARFIELD E. BREESE,
411 First National Bank Bldg.,
Mason City, Iowa.
Amicus Curia.

P. 2

SUPREME COURT OF THE UNITED STATES.

No. 743.—October Term, 1935.

Frank O. Lowden, James E. Gorman and Joseph B. Fleming, as Trustees of the Estate of the Chicago, Rock Island and Pacific Railway Company.

vs.

Northwestern National Bank and Trust Company of Minneapolis, Minnesota, Formely the Northwestern National Bank of Minneapolis, Minnesota.

On Certificate from the United States Circuit Court of Appeals for the Eighth Circuit.

[April 27, 1936.]

Mr. Justice Cardozo delivered the opinion of the Court.

On June 7, 1933, the Chicago, Rock Island and Pacific Railway Company filed in the United States District Court for the Northern District of Illinois its petition for reorganization under § 77 of the Bankruptcy Act. 11 U. S. C. § 205.* At that time the railroad had to its credit the sum of $36,908.72 in a checking account with the Northwestern National Bank and Trust Company of Minneapolis. The bank was then the owner of First and Refunding Gold Bonds issued by the railroad of the par value of $100,000, not yet in default in respect of principal or interest. On June 19, 1933, seven days after receiving a copy of an order approving the petition for reorganization, the bank set off the deposit against the bonds by appropriate entries upon its books of account. Trustees of the estate of the railroad were appointed by the court in accordance with the statute, though whether before the attempted set-off or thereafter the record does not tell us. They brought suit against the bank in the United States District Court for Minnesota, not the court of bankruptcy administration, to recover the amount of the deposit set off against the bonds. After answer by the bank and a trial of

* The references in this opinion are to § 77 as enacted March 3, 1933, 47 Stat. 1474, and not to the amendments of August 27, 1935, 49 Stat. 911, 926.

the issues, the court entered a decree upholding the validity of the set-off, with a correction not now material as to the amount of the deposit. 11 F. Supp. 929. The trustees appealed to the Circuit Court of Appeals for the Eighth Circuit. That court, after certifying the facts substantially as summarized above, requested our instructions upon the following questions (Judicial Code, § 239; 28 U. S. C. § 346):

"Question 1. Does the right of set-off recognized by section 68 (a) of the Bankruptcy Act apply to reorganization proceedings under section 77 of that act?

"Question 2. If the first question be answered in the affirmative, can a bank which owns the unmatured bonds of a railroad corporation set off a deposit account of the railroad with the bank against the bonds, upon the filing by the railroad of a petition for reorganization under section 77 of the Bankruptcy Act, alleging that the railroad is unable to meet its debts as they mature?

"Question 3. If the first and second questions be answered in the affirmative, may the United States District Court, for the District of Minnesota, in the suit by the trustees of the railroad's estate to recover the amount deducted from the account of the railroad by the bank under the claimed right of set-off, recognize and establish as a proper set-off by the bank one which was not made until after the filing of the petition for reorganization and which has never been ordered, authorized, approved, or consented to by the court in which that petition was filed and approved?"

This court has had occasion recently to restate the rules announced in earlier decisions as to the mode of formulating questions coming here upon certificates. *Mantle Lamp Co. of America* v. *Aluminum Products Co.*, No. 590, March 30, 1936, —— U. S. ——. We will not answer abstract questions unrelated to the pending controversy, or questions unnecessarily general, or questions which admit of one answer in one set of circumstances and a different answer in another, the differentiating circumstances being imperfectly disclosed. *White* v. *Johnson*, 282 U. S. 367, 371; *United States* v. *Mayer*, 235 U. S. 55, 66; *United States* v. *Hall*, 131 U. S. 50, 52; *Webster* v. *Cooper*, 10 How. 54, 55; *Hallowell* v. *United States*, 209 U. S. 101, 107; *General Motors Corp.* v. *United States*, 286 U. S. 49, 63. The questions now before us have been framed without adequate regard to these established rules of practice.

Question No. 1 is too general and abstract, its relation to the controversy being indirect and problematical. "In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off

against the other, and the balance only shall be allowed or paid." Bankruptcy Act, § 68 (a); 11 U. S. C. § 108. The precept, framed on the example of ancient laws across the seas (4 Anne, c. 17, § 11; 5 Geo. II, c. 30, § 28), is now applicable by force of statute to the liquidation of estates in bankruptcy. We are asked to announce broadly whether it is applicable with similar inclusiveness to proceedings to reorganize a railroad, though the question tells us nothing as to the facts behind the controversy. "The court has repeatedly held that it will not answer questions of objectionable generality." *White* v. *Johnson, supra; United States* v. *Worley,* 281 U. S. 339, 340; *United States* v. *Mayer, supra.* Without a showing of the facts an answer to this question would declare a mere abstraction which might seem too narrow or too broad thereafter when the facts were shown forth. One must see the controversy in its setting before the implications of a ruling can be prefigured with assurance.

Question No. 2 is dependent by its terms upon an affirmative answer to question No. 1. It is open, however, to objections on its own account. Like question No. 1 it is far too general in its range. Moreover, it is silent as to facts which a court of equity should know before hazarding an answer. A proceeding to reorganize is not a bankruptcy, though an amendment to the bankruptcy act creates and regulates the remedy. From the fact without more that such a proceeding has been initiated, one cannot know that it will be necessary to have recourse to § 68, which was meant in its enactment to prescribe the rule of set-off upon a distribution of the assets. That stage of administration, or the analogous stage of a revision of the debts, may never be attained in a proceeding to reorganize, though a petition has been approved and trustees have been appointed. If a plan of reorganization is not proposed or accepted, or, being proposed and accepted, is not confirmed by the court within a reasonable time, the whole proceeding may be dismissed (§ 77 (c) (7)), the title to the estate thus reverting to the debtor. By that time there may even be ability to pay demands as they mature. What is done at the beginning amounts to little more than a provisional sequestration to give protection for the future.

The right of set-off must fit itself to these procedural conditions. It is not susceptible of definition in the abstract without reference to the time or occasion of the controversy or the relation of the suit

to the primary proceeding. Irrespective of the acceptance or confirmation of a plan, the trustees must have the power to gather in the assets and keep the business going. To exercise that power, they may find it necessary to sue, and the suit may turn upon the right of set-off, as it does in the case at hand. In a suit for such a purpose, a suit collateral to the main proceeding and initiated at a time when the outcome of that proceeding is still unknown and unknowable, § 68 of the statute does not control the disposition of the controversy *ex proprio vigore.* It governs, if at all, by indirection and analogy according to the circumstances. The rule to be accepted for the purpose of such a suit is that enforced by courts of equity, which differs from the rule in bankruptcy chiefly in its greater flexibility, the rule in bankruptcy being framed in adaptation to standardized conditions, and that in equity varying with the needs of the occasion, though remaining constant, like the statute, in the absence of deflecting forces. *Scott* v. *Armstrong,* 146 U. S. 499, 507; *North Chicago Rolling Mill Co.* v. *St. Louis Ore & Steel Co.,* 152 U. S. 596, 615; *Scammon* v. *Kimball,* 92 U. S. 362, 366; *Sawyer* v. *Hoag,* 17 Wall. 610, 622; *Clark Bros. & Co.* v. *Pou,* 20 F (2d) 74, 77, 78; *Greene* v. *Darling* (Story, J.), 5 Mason 201, 210; *Gray* v. *Rollo,* 18 Wall. 629, 632; *Dade* v. *Irwin's Executor,* 2 How. 383, 390, 391; *Studley* v. *Boylston National Bank,* 229 U. S. 523, 528, 529; *Pond* v. *Harwood,* 139 N. Y. 111, 119; *Frank* v. *Mercantile National Bank,* 182 N. Y. 264, 268; *Lockwood* v. *Beckwith,* 6 Mich. 168, 175; Story, Equity Jurisprudence, 14th ed., §§ 1871, 1872.

The defects of the certificate, its incomplete disclosure of the facts conditioning an answer, are thus exhibited in clear relief. "Insolvency" in proceedings to reorganize (§ 77) is often very different from "insolvency" in ordinary bankruptcy (§ 1 (15)). There is at least a possibility that at times the difference may be great enough to vary the resulting equities. When things are called by the same name it is easy for the mind to slide into an assumption that the verbal identity is accompanied in all its sequences by identity of meaning. A court of equity in allowing or rejecting set-off will not be guilty of that fallacy. To know "the justice of the particular case" (*Scott* v. *Armstrong, supra;* Story, Equity Jurisprudence, *supra*), one must know the case in its particulars. More concretely, one must know the value of the assets, the tem-

porary or permanent character of the debtor's inability to pay its debts as they mature, the liens, if there are any, superior to the bonds in controversy, the probability of an understanding that the bonds, though unmatured, would be used to cancel the deposits, all the circumstances, in brief, that might affect the judgment of the chancellor in weighing the competing equities of the interested factions and shaping his decree accordingly. We have no thought at this time to foreshadow the result of an exploring expedition directed to those ends. When all the facts are known, they may be found to offer no excuse for a departure from the rule in bankruptcy which, as indicated already, is generally, even if not always, the rule in equity as well. They may point, on the other hand, to the need for an exception, or may even lead to a decree in the nature of a compromise, the moneys being paid into the registry of the court to abide its future action. A decision balancing the equities must await the exposuré of a concrete situation with all its qualifying incidents. What we disclaim at the moment is a willingness to put the law into a strait-jacket by subjecting it to a pronouncement of needless generality.

Question No. 3 is so framed as not to call for an answer unless an affirmative answer is given to questions Nos. 1 and 2.

Our conclusion as to the defective form of the certificate is borne out in a striking way by the concession of the parties. Before the argument on the questions, plaintiffs and defendant joined in moving us for an order to bring up the whole case. That motion was denied. Nothing in the nature of the controversy called for a writ of certiorari in advance of a decision by the court of intermediate appeal. The significant thing, however, is that in briefs submitted on that motion both parties admitted that the second question was defective. The plaintiffs said: the statement "is not sufficiently complete to enable this court to answer the second question as applied to this case." The defendant made a like objection. Plaintiffs and defendant fortified their general criticism by the enumeration of particular defects.

The certificate is

Dismissed.

A true copy.

Test:

Clerk, Supreme Court, U. S.